

Office of the Under Secretary of Defense (Comptroller) (OUSD(C))



Preparing for an Audit

Student Guide

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Course Title **Preparing for an Audit**

Course Identification

Course Code: OSD-P4AUD

Course Type: F

Level and TypeIntroductory Functional Course

Course Length

8 hours

8 CPE credit hours

Field of StudyAccounting and Audit, Government Accounting and Reporting – Specialized.

Course Description

The Preparing for an Audit course, Version 1.0, is an eight-hour, introductory functional course designed to provide individuals who require an understanding of the complexities surrounding financial statements audits with the basic knowledge and skills needed to properly prepare for audits in the Department of Defense (DoD) environment. This course is designed to be a hands-on, “how to” course, focused on providing students with the necessary tools to prepare for a successful audit. Students learn the key legislative and regulatory requirements for conducting government audits, how to recognize key financial statements necessary for the DoD consolidation, understand the types of federal audits, and complete the phases involved in achieving a clean unqualified audit. Students will also learn how virtually every DoD job, whether financial or non-financial, contributes to specific components of the financial statements. Additionally, students will be provided with useful tools for satisfying independent audit requirements.

Learning Objectives

Upon completion of this course, the student will be able to:

- describe the value of financial statement audits and why they are performed
 - describe how the auditable data links into the DoD Financial Statements
 - discuss the steps to take to prepare to assert audit readiness.
-

Presentation Mode

The primary method of instruction for this functional course is instructor presentation, conference, and questions and answers.

Who Should Attend

The audience for this course is civilian and military personnel of various grades and ranks. It consists of both financial and non-financial personnel who desire to improve their operations while satisfying Congressional and regulatory audit requirements.

Prerequisites

There are no prerequisites for this course.

Course Agenda

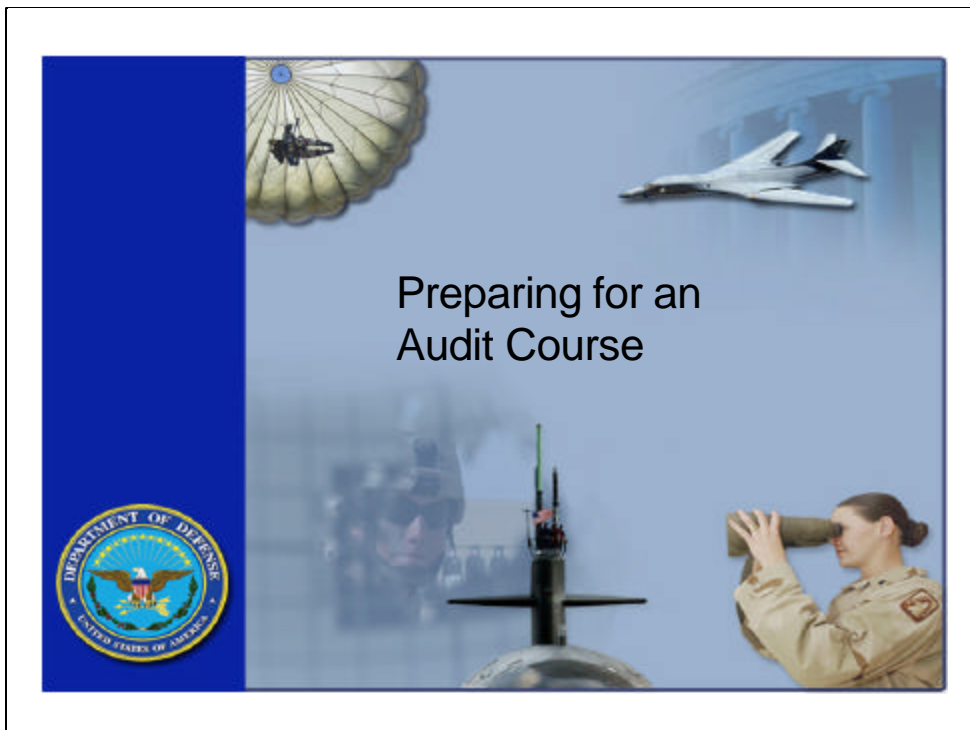
8:00-8:10	Course Introduction
8:10-8:50	Lesson 1 – Why Audit?
9:00-9:50	Lesson 1 – Why Audit? (cont.)/Lesson 2 – Auditable Data and Audit Methodology
10:00-10:50	Lesson 2 – Auditable Data and Audit Methodology (cont.)
11:00-11:50	Lesson 2 – Auditable Data and Audit Methodology (cont.)
12:00-1:00	Lunch
1:00-1:50	Lesson 3 – Steps for a Clean Audit
2:00-2:50	Lesson 3 – Steps for a Clean Audit (cont.)
3:00-3:25	Lesson 3 – Steps for a Clean Audit (cont.)
3:25-3:45	End-of-Course Review
3:45-4:25	Final Examination and Final Examination Review
4:25-4:45	Course Critique

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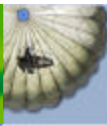
Good morning and welcome to the Preparing for an Audit course.



Course Introduction



- **Meet your instructor**
- **Housekeeping issues**
- **Other**



Course Logistics



Starting Time



Coffee Breaks



Restrooms



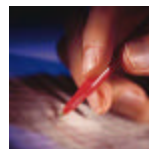
Cell Phones



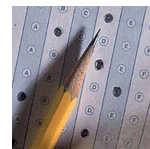
Lunch Break



Phone Calls





Nondisclosure





Exercise/Exam






















During this discussion, you will be provided with examples of financial transactions and other proprietary information either from the instruction or from your classmates. You must assume that this information is not for use by the general public, nor is it to be published or disseminated to third parties.

The format for this class is conference/lecture and will include questions and discussion. There are no practice exercises, but there is a final examination. You may use any materials provided in the course or discussion to complete this examination.

Icon Definitions

Course/Lesson Flow		Course Topics	
	Logistics	Key Point 	Steps 
Starting Time 		 Definition	 Goal
 Objectives		Background 	Quote 
Summary 		 Detail	 Tools
 Questions		Law/Standard 	Information 
Exercise/Exam 		 Example	 Best Practice
 References		Report 	Issues/Resolutions 

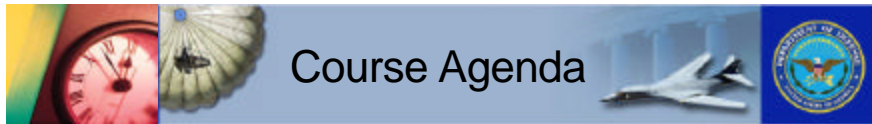
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Notice that each page is formatted with a header. The left corner of each header contains an icon that provides a visual key to the contents of the page. For example, this page displays the Logistics icon.

The main icons describe course and lesson objectives and introduce key topics. Additional icons within each topic represent definitions, background information, and issues and resolutions. Best Practice and Lessons Learned icons will show examples of successful practices implemented by the government or industry. At the conclusion of each lesson, icons will represent the lesson summary, questions and answers, final examination, and references for more information.

Please feel free to take notes in the space provided on your student materials, and to write down any questions that you may have that we may not have had time to address during the discussion of a particular topic. Your questions are very important to us, but we may not have the answer or sufficient time available in the classroom and may have to go to an outside source for an answer.

Now let's examine the course agenda.



Time	Title
8:00 - 8:10	Introduction
8:10 - 9:40	Lesson 1, Why Audit?
9:40 - 12:00	Lesson 2, Auditable Data and Audit Methodology
12:00 - 1:00	Lunch
1:00 - 3:30	Lesson 3, Steps for a Clean Audit
3:30 - 3:40	End-of-Course Review
3:40 - 4:30	Final Examination and Review
4:30 - 5:00	Course Critique

Class starts promptly at 8:00 a.m., and will break for ten minutes each hour.

Lunch is scheduled from 12:00 to 1:00, and the course ends at 5:00 p.m.

In this course, there are three lessons, an end-of-course review, and a final examination. Lessons 1 and 2 should be completed before lunch, and Lesson 3 begins after lunch. Finally, you will complete a course critique and the instructor will distribute the course completion certificates.

Let's discuss the purpose and objectives.



Course Overview



This course is designed to explain why financial statement audits are conducted, what data is auditable and how it is audited, and the steps to take to prepare to assert audit readiness.

It is important because you need to know what is required of each member of your organization to be able to successfully complete a financial statement audit.

When your organization is prepared to assert audit readiness, you will have thoroughly examined your process, procedures, and policies.

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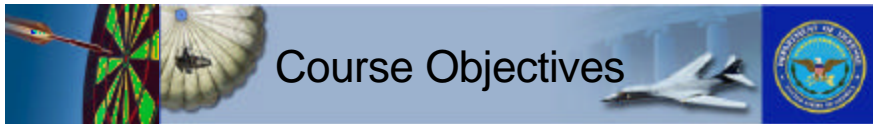
CI-6

This course is designed to explain why financial statement audits are conducted, what data is auditable, how data is audited, and what steps can be followed to assert audit readiness.

This is important because you need to know what is required and expected of you and other members of your organization to be able to successfully complete a financial statement audit and be prepared to assert audit readiness.

When your organization is prepared to assert audit readiness, you will have thoroughly examined your process, procedures, and policies. You will also have identified deficiencies, corrected them, and verified those corrections. In asserting your audit readiness, you are affirming the reliability of your financial information in preparation for assessment or audit.

Let's look at the course objectives.



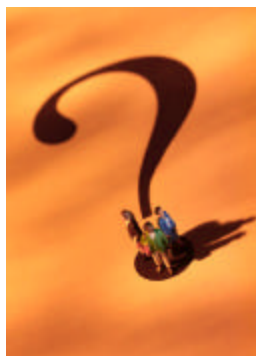
Upon successful completion of this course, you will be able to:

- **describe the value of financial statement audits and why they are performed**
- **describe how the auditable data links into the DoD Financial Statements**
- **discuss the steps in preparing to assert audit readiness.**

This course begins by describing the value of financial statement audits. We will define a financial statement audit, discuss why it is performed, and examine the legal and regulatory requirements for audits.

We will then describe how the auditable data links into the DoD Financial Statements by examining feeder systems, information flow, and the methodology used to conduct the audit.

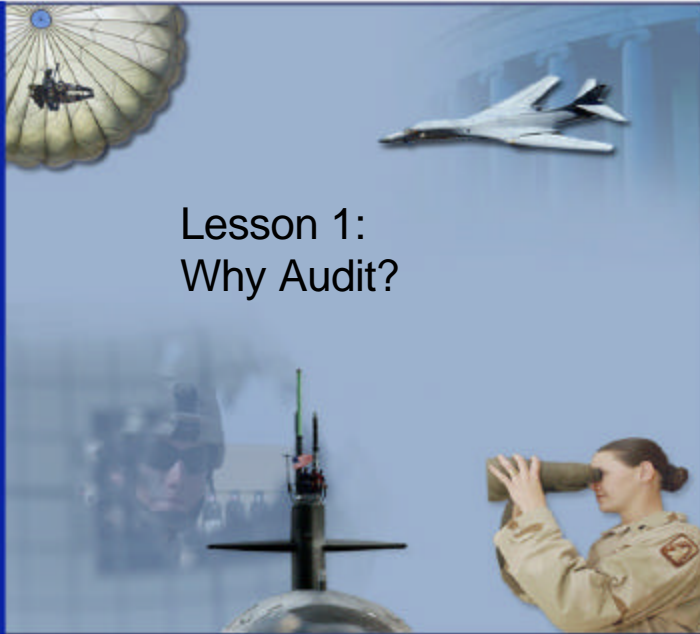
Finally, in describing the steps to take to prepare for a clean audit, we will discuss the five-phase process used by the Department's leadership to prepare to assert audit readiness. These steps are designed to move the entity's financial statements from a position of unreliability to reliability and, ultimately, to an unqualified audit opinion.



Preparing for an Audit



Lesson 1: Why Audit?



In Lesson 1, we will explore why audits are required and necessary.



Lesson Objectives



Upon successful completion of this lesson, you will be able to:

- **explain the purpose and value of financial statement audits**
- **define common auditing terms**
- **explain why we do financial statement audits**
- **describe how to link the information within the key components of the financial statements**
- **identify various government auditing entities**
- **identify the applicable hierarchy of the guidance used for audits of the financial statements.**

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To understand why audits are required and necessary, it is important that you understand the history for the requirement to report on the use of resources; the legal and regulatory guidance that requires the application of accounting standards, reporting, control, and accountability; and the goals of the Department in obtaining an unqualified or clean audit opinion.

With an understanding of the purpose and value of financial statement audits, common auditing terms, and why we do financial statement audits, you begin to understand your role in the accomplishment of the Department's goals. You explore the requirements for financial statements and then familiarize with how the information within these statements is linked to form a picture of your organization.

You then identify various government auditing entities, and the applicable hierarchy of the guidance used for audits of the financial statements.



Lesson Topics



This lesson contains the following topics:

- **Overview of Audits**
- **Purpose of Audits**
- **Audit Value**
- **Common Auditing Terminology**

In the Overview of Audits topic, you will become familiar with various types of audits. We will then discuss the purpose of audits, where you will become familiar with the scope of the operations and why the audit of these operations is important. In discussing audit value, you will learn about the types of audit opinions and the value of an unqualified audit opinion.

Familiarity with common auditing terminology assists you in an understanding of the language used by auditors to express an opinion and what that opinion means to users of the financial statements.

Let's examine a few more topics.



Lesson Topics



Additional topics:

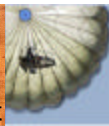
- **Compliance with Legal Requirements**
- **Financial Statements**
- **Compliance with Regulatory Requirements**
- **Federal Government Auditing Entities**
- **Applicable Guidance**

The requirement for compliance with legal and regulatory requirements is the foundation for understanding the reason why various policies and procedures must be followed. These procedures affect the preparation and audit of the financial statements. Federal government auditing entities provide audit services at various levels of the organization. In providing these services, auditors and those being audited should understand the applicable guidance.

Let's begin with an overview of audits.



Overview of Audits



“No money shall be drawn from the Treasury, but in consequence of appropriations made by law; and a regular statement and account of receipts and expenditures of all public money shall be published from time to time.”

Article 1, Section 9, Clause 7, Constitution of the U.S.

The accountability clause of the U.S. Constitution (Article I, Section 9, Clause 7) links the legal expenditure of appropriations to the reporting of transaction information and account balances. What this means to you is that there is a long history for the requirement to report on the use of resources. Up to 1990, that reporting did not receive an audit.

So what does auditable mean? It means that the auditors can take the information as reported on the financial statements and be able to trace the reported information all the way to sets of source documentation. From the source documentation, a select group of transactions is tested to verify accuracy, validity, legality of the transactions and supporting procedures, and adequate documentation with supporting signatures.

Once the sample financial information has passed the testing process, the auditors express an opinion on the credibility of the financial information that is supported by the selected samples.

Our goal is a clean or unqualified audit opinion.



Overview of Audits (cont.)



Financial audits report on:

- **financial position**
- **compliance with laws and regulations**
- **internal controls.**

Performance or operational audits report on:

- **effectiveness**
- **economy and efficiency**
- **compliance.**

Systems audits report on:

- **system capability and internal control.**

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There are three types of audits: financial audits, performance or operational audits, and systems audits. Financial audits report on whether or not an entity's financial reports fairly reflect the true financial position of that entity as of a particular point in time such as the end of the fiscal year (September 30) or the end of a quarterly reporting cycle such as December 31, March 31, or June 30. The Department is required to prepare quarterly financial statements. Using statistical techniques, interviews, and other analytical methods, auditors attempt to determine if balances and related notes presented in the financial statements fairly represent the operations of the entity. The auditors' report then states an opinion as to that presentation. They also report on whether the entity's operations substantially comply with legal and regulatory guidance, the degree to which non-compliance affects the results of operations. Financial audits may also report on the internal controls over the assets of an entity. Internal controls are the practices and procedures that are used to safeguard your assets such as password protection, locks, separation of duties, and others.

Performance or operational audits report on the effectiveness, economy and efficiency, and, in certain circumstances, compliance aspects of a particular activity. They concentrate on mission accomplishment and use of resources.

Systems audits report on the ability of financial management and feeder systems to provide required financial information and whether or not the internal controls of the system are adequate for the prevention of fraud, waste, and abuse.



Overview of Audits (cont.)



How does financial reporting affect the way we do business and why is that important to you?

Financial management is on Secretary Rumsfeld's top 10 priorities.

How does that reporting affect the way we do business and why is that important to you? In the last several years, substantial improvement of the Department's financial management has been a top priority. It is on the top 10 priorities of Secretary Rumsfeld. This is due in part to the conclusions reached by the Department's leaders that the DoD's financial management deficiencies were more fundamental and entrenched than previously recognized. The remedy has been the most comprehensive reform of financial management systems and practices in the Department's history.

Let's examine the scope of activities that are being reformed.



Purpose of Audits



DoD employs 1.4 million active duty and 1.2 million guard and reserve personnel, 740,000 civilians, and supports 2.1 million retirees and surviving spouses. It has 600,000 individual buildings and structures at over 6,000 locations. It uses about 250,000 vehicles, more than 15,000 aircraft, and 1,000 oceangoing vessels.

Its annual appropriated budget is \$468.6 billion. Its Military Retirement fund reports \$830 billion in liabilities, and its Military Health fund reports \$600 billion in liabilities.

Source: 2004 DoD Performance and Accountability Report

<http://www.defenselink.mil/comptroller/par/>

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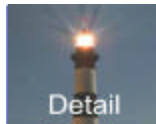
Preparing for an Audit

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As cited in the 2004 DoD Performance and Accountability Report (PAR), an annual report on the operational and financial performance of the Department, the DoD is one of the largest and most complex organizations in the world. It annually reports hundreds of billions of dollars in assets. The Department is responsible for liabilities of about 1 trillion dollars. Each fiscal year, it recognizes several hundred billion dollars of revenues, financing sources, and incurred expenses.

The Department, through its military services and its combatant commands, carries out its mission and programs on a worldwide basis. The scope of its operations dwarfs those of most large corporations and many autonomous countries. All of those activities affect the department's financial status. Obviously, it is critical that the DoD have high quality financial management systems, and data from its operational and support systems, to meet its financial requirement to efficiently and effectively perform its missions.

The DoD operates thousands of automated information systems – financial, non-financial, and mixed – in executing its missions and programs. Although the Defense Finance and Accounting Service (DFAS) is responsible for the majority of the Department's financial systems such as entitlement, disbursing, and accounting systems, DFAS is not responsible for all of the systems or documentation that support financial management data. Non-DFAS systems that support other functional areas, including acquisition, logistics, property management, and personnel, generate and process a significant amount of data that are ultimately used by the Department for management, analysis, and financial reporting.



Purpose of Audits (cont.)



Why we perform audits:

- It demonstrates financial condition and accountability.
- It's the responsibility of the government to it's citizens.
- It's the law.

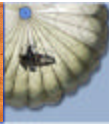
Bottom line: Better and more reliable information means better decisions by the Department's leadership.

Now that you know the scope of the operations, you need to know why the audit of these operations is important.

When we properly control and account for the resources used at every level of our operations, and ensure that the data used to inform our leaders on the status of their resources is reliable and timely, we provide them with the means to make informed decisions.

How many of you would invest in a company with a budget of over \$400 billion yet cannot obtain a favorable audit opinion? We establish credibility and trust when we obtain a favorable opinion on a financial statement audit, and it's the responsibility of the government to it's citizens to ensure that trust. Ensuring the public trust is also the foundation for many of our laws.

Let's discuss how audits provide value in the decision-making process.



Audit Value



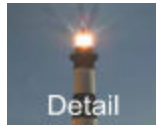
Audit value in the decision-making process...

- **Financial data is used to estimate the costs of operations, programs, and activities.**
- **Audits provide a means of testing current data and reporting and control procedures to validate whether or not those procedures would enable users of the financial data to rely on the underlying information that supports the reported financial data.**

DoD leadership at all levels, from the unit commander to the Commander in Chief, must be able to trust the information provided through the reporting processes. One of the most essential elements of information is financial data. Financial data is used to estimate the costs of operations, programs, and activities. To estimate future costs, and therefore to request appropriate levels of funding, the actual costs of such items as equipment, training, supplies, personnel, research and technology, weaponry and ammunition, fuel, transportation, medical care, land, rents, vehicles, clothing, food, utilities, buildings, and maintenance must be known.

Audits provide a means of testing current data and reporting and control procedures to validate whether or not those procedures would enable users of the financial data to rely on the underlying information that supports the reported financial data. In preparation for an audit, your organization uses the same procedures that would be used by an auditor to identify weaknesses within your organization's reporting and control procedures. Once identified, efforts are made to correct these weaknesses and therefore strengthen the reliability of the supporting data.

Using the assertion process/program that we will discuss later and once your organization is ready for an audit, auditors analyze the underlying data, policies, procedures, and controls to ensure that they provide adequate control over your resources and the associated reporting on the use of those resources. As mentioned earlier, it is a top priority of the DoD to achieve an unqualified audit opinion on the Department-wide financial statements.



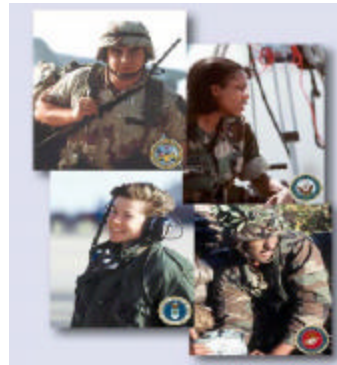
Audit Value (cont.)



The value of an unqualified audit opinion....

It implies:

- **reliability of financial data**
- **systems are adequate for the needs of decision-makers**
- **a standard of control that helps to ensure the prevention of fraud, waste, and abuse.**



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An unqualified audit opinion is a seal of approval from the audit community that is recognized by the business and financial community. To understand why this opinion is so valuable, it's important to understand the benefits to be gained by achieving this goal.

The DoD, as an entity of the federal government, and your organization, as an entity of the Department, must obtain a favorable audit opinion to enable the federal government's financial statements to be accepted as a representation of accurate information. An unqualified audit opinion not only implies reliability of financial data, it implies that the systems supporting the reporting of financial data are adequate to meet the needs of the decision-makers for timely and accurate data. It implies a standard of control over the resources of your organization to ensure that they are protected from fraud, waste, and abuse.

It does not imply that minor deficiencies will not occur, nor does it imply that a person with the intent to cause harm will not be able to do so. Errors or misstatements occur, and no system is invulnerable to collusion or sabotage. However, internal controls must be sufficient to fend off most attempts.

Now let's look at some common audit terminology.



Common Auditing Terminology



Sampling -

Statistical (and non-statistical) tools selected for testing items from a specific class of transaction, account balance, or other characteristic. Amount of sampling is based on the auditor's assessment of internal controls.



Evidential matter -

Any item requested by audit staff (financial statements, documents, records, policies, procedures, reports)

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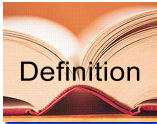
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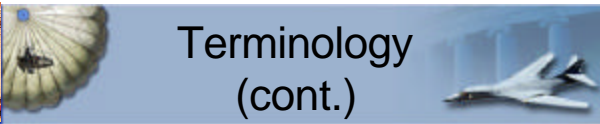
To understand the language used in the audit process, it is important to become familiar with some of the key words and phrases used. Some are introduced here, and others are introduced in Appendix A of your student handout. The definitions in Appendix A are a compilation of accounting and auditing terms used in textbooks, dictionary definitions, and common usage within the finance community.

Auditors use many different tools when conducting an audit. Sampling and the examination of evidential matter are two of them. The amount of sampling required is based on the auditor's assessment of your internal controls. Reviewing all the items from a specific class of transaction, account balance, or characteristic is time-consuming and costly. To streamline the audit effort, various audit sampling methods are used. There are two types of sampling: statistical and non-statistical. When used properly, both non-statistical and statistical sampling provide sufficient evidential matter for the audit. Statistical sampling is described in further detail in Lesson 2.


Evidential matter consists of the financial statements, documents, records, policies, procedures, controls, management assertions, results of previous inspections, and any other items requested by the audit staff to support the auditors' opinion on the reliability of the financial statements and accompanying notes. Though introduced in this course, the How to Manage Audit Evidential Matter course provides greater detail into this key subject.



Definition



Terminology (cont.)



Reasonable Assurance - Assurance that a reasonable person can reach the same conclusion given the same data and circumstances. Not an absolute certainty.

Materiality - Degree of importance or consequence.

Sample Auditor's Standard Report

Report of Independent Public Accountants
To appropriate officials of the organization requesting the audit.

We have audited the accompanying consolidated financial statements as of (a specified date or period covered). These financial statements are the responsibility of (the entity's) management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted government auditing standards, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. Compliance with laws, regulations, contracts, and grants applicable to (the entity) is the responsibility of (the entity's) management.

An audit includes examining on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respect, the financial position of (the entity) as of (the specified date or period covered), and the results of their operations and their cash flows for the periods stated, in conformity with generally accepted accounting principles.

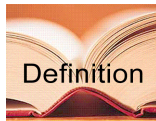
Signature of auditor and date

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The auditors' opinion is based on reasonable assurance, as opposed to certainty. The prescribed language of the audit report ensures that the auditors define the limits of their assurance. The auditor must test on a sample basis enough evidential matter to reasonably assure that the financial statements present fairly, in all material respects, the financial position of the organization being audited.

By using the phrase "in all material respects," the auditor states the degree to which the information may be relied upon. The concept of materiality allows that minor deviations in account balances or procedures may have no effect on the reliability of the statements as a whole for example, a \$1 hundred deviation on a \$1 million account balance. Using this same concept, it is possible that the auditors opinion may be qualified by an amount or procedure that does in some way affect the reliability of the financial statements for example, that \$1 hundred deviation had to do with a trend that if not corrected would have a major effect on the financial statements. A material weakness is a weakness in management controls that warrants reporting to a higher level.

There are specified amounts that are considered material depending on the type of account or activity. The auditor sets the materiality at the beginning of the audit using guidance contained in the Government Accountability Office/President's Council on Integrity and Efficiency Financial Audit Manual (GAO/PCIE FAM) (discussed in further detail in Lesson 2 of this course). This is done for each audit and it varies.



Terminology (cont.)



Unqualified opinion -

Opinion that is without any material exception as to a general statement of reliability of the items specified within the limits of the audit.

Qualified opinion -

Opinion stating that except for the effects of the matter(s) to which the qualification relates, the financial statements present fairly the financial position of the organization.

Adverse opinion -

Opinion stating that the financial statements do not present fairly the financial position of the organization.

Disclaimer of opinion -

Auditor does not express an opinion on the financial statements.

Auditable -

Underlying data and procedures are sufficient, accurate, testable, and reliable enough for the auditor to obtain a basis for forming an unqualified opinion.

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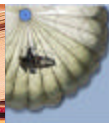
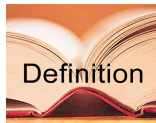
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An unqualified opinion is the most preferred finding. An unqualified opinion has no material exception as to a general statement of reliability. Any other opinion is deemed to be a result of one or more material departures from the generally accepted accounting principles, or the auditors have been unable to obtain sufficient evidence regarding one or more of the management's assertions, and as a result, do not have a reasonable basis for an unqualified opinion on the financial statements as a whole.

Examples of other opinions are: a qualified opinion which states that except for the effects of the matter(s) to which the qualification relates, the financial statements fairly present the financial position of the organization; an adverse opinion which states that the financial statements do not fairly present the financial position of the organization; or a disclaimer of opinion which states that the auditor does not express an opinion on the financial statements.

To be eligible for an unqualified audit opinion, the financial statements must be fully auditable and be compiled in accordance with generally accepted accounting principles. That means that the underlying data and procedures must be sufficient, accurate, testable, and reliable enough for the auditor to obtain a basis for forming an unqualified opinion.



Terminology (cont.)



Assertion -

Explicit and implicit information provided by management that attests to the represented financial position or results of operations.

Deficiency -

Lacking in adequate competence, readiness, knowledge, or means.

Systemic weakness -

Material weakness that affects management controls across organizational and program lines and usually affects multiple DoD components.

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Auditors base their opinions upon management's assertions as to the existence or occurrence, completeness, rights and obligations, valuation or allocation, and presentation and disclosure of reported data. For example, management asserts that the amount reported as inventory is based on the existence of appropriate Operating Material and Supplies (OM&S) or other items of inventory required to be reported within the line item of the financial statement as of the reporting date; that the reported inventory is complete; that it belongs to the reporting entity; and that it is stated at its proper value. Further definitions of these assertions can be found in Appendix A of your student handout.

When the auditors, in the course of their examination, find that an error exists in an area asserted by management, that error is classified as a deficiency. A deficiency can be immaterial and have no effect on the overall assertions of management such as a minor recording error traceable to a single document, or it can be a significant problem that involves an entire process such as an inability to verify the value or ownership of property.

Systemic weaknesses are material weaknesses that affect management controls across organizational and program lines and usually affect multiple DoD components.

Now that you are familiar with a few of the common audit terms, let's discuss the legal and regulatory guidance that explains why we do financial statement audits.



Compliance with Legal Requirements



Legislative requirements for the application of accounting standards, reporting, internal control, and accountability:

- **Federal Financial Management Improvement Act of 1996 (FFMIA)**
- **Federal Manager's Financial Integrity Act of 1982 (FMFIA)**
- **Inspector General Act Amendments of 1988, and the Chief Financial Officers Act of 1990 (CFOA)**

Compliance with legal and regulatory requirements is one of the first items checked in an audit of an organization. The requirement for the audit of the DoD financial statements and the results of operations are embedded within this guidance.

Let's begin with the legislation.



Legal Requirements (cont.)



Federal Financial Management Improvement Act of 1996 (FFMIA)

Each agency must implement financial management systems that comply substantially with federal financial management systems requirements, applicable federal accounting standards, and the United States Standard General Ledger (USSGL) at the transaction level.

Federal Managers' Financial Integrity Act (FMFIA)

Systems of internal accounting and administrative control of each executive agency must be established in accordance with the standards prescribed by the Comptroller General.

FFMIA: <http://www.ignet.gov/pande/faec/gaoffmia.pdf>

FMFIA: <http://www.whitehouse.gov/omb/financial/print/fmfia1982.html>

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The FFMIA is designed to increase the accountability of managers of federal resources. It requires all federal agencies to comply with federal accounting standards and reporting objectives in their financial management systems in order to support full disclosure of federal financial data, including the costs of federal programs and activities. It stipulates that each agency must implement financial management systems that comply substantially with federal financial management systems requirements, applicable federal accounting standards, and the USSGL at the transaction level.

In addition to the FFMIA, the FMFIA stipulates that the systems of internal accounting and administrative control of each executive agency must be established in accordance with the standards prescribed by the Comptroller General. The Office of Management and Budget (OMB) has established guidelines in OMB Circular A-123, Management's Responsibility for Internal Control, which was recently revised to strengthen the assessment of internal controls over financial reporting. We will discuss the reporting requirements under the FMFIA in our discussion of this OMB guidance later in this lesson.

Notice that your slide includes Web references for your use in obtaining further information on this subject. In addition, a consolidated list of web references is included at the end of each lesson.

Let's examine more legislation.



Legal Requirements (cont.)



**The Inspector General Act
requires an explanation for
all audit reports with
recommendations open for
more than one year.**



Inspector General Act: <http://uscode.house.gov/uscode-cgi/fastweb.exe>

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In addition to the identification of weaknesses required by the full reporting provisions of the FFMIA, and the internal evaluation of internal controls required by the FMFIA, the amended Inspector General Act requires an explanation for all audit reports with recommendations open for more than one year.

Currently there are 11 material weaknesses reported in the DoD FY 2004 PAR. These weaknesses concern such matters as financial management systems, intra-governmental eliminations, accounting entries, Fund Balance with Treasury, environmental liabilities, General Property, Plant, and Equipment (PP&E), Government Property and Material in the Possession of Contractors, inventory, OM&S, presentation of the Statement of Net Cost, and reconciliation of the Statement of Financing.

Let's look at one of these identified weaknesses as reported in the PAR.



Legal Requirements (cont.)



Systemic Weakness

Title	Description of Issue	Progress to Date
Department of Defense (DoD) Financial Management Systems and Processes	The DoD financial and business management systems and processes are costly to maintain and operate, not fully integrated, and do not provide information that is reliable, timely, and accurate.	Completed Milestones: <ul style="list-style-type: none">• Created a portfolio management approach to review information technology investments.• Incorporated the Enterprise Business Process Model into the Business Enterprise Architecture release 2.1.• Established integrated goals, objectives, measures, and targets.• Initiated a single Department-wide information technology registry to track all business systems.

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The DoD reports two types of weaknesses: material weaknesses, which usually affect only one DoD component, and systemic weaknesses, which are more pervasive problems that usually affect more than one DoD component or cross organizational lines.

This is an example of one systemic weakness reported in the DoD FY 2004 PAR.

The problem is that the DoD financial and business management systems and processes are costly to maintain and operate, are not fully integrated, and do not provide information that is reliable, timely, and accurate. To help resolve it, the Department has taken some aggressive steps, but has many actions left to complete.



Legal Requirements (cont.)



Systemic Weakness (cont.)

Title	Description of Issue	Progress to Date (cont.)
Department of Defense (DoD) Financial Management Systems and Processes	The DoD financial and business management systems and processes are costly to maintain and operate, not fully integrated, and do not provide information that is reliable, timely, and accurate.	Planned Milestones for FY 2005: <ul style="list-style-type: none">• Complete the Business Enterprise Architecture (BEA) Increment #1, which includes business processes in support of an unqualified audit opinion.• Perform targeted portfolio management reviews as part of the FY 2005 through FY 2006 planning, programming, and budgeting process.

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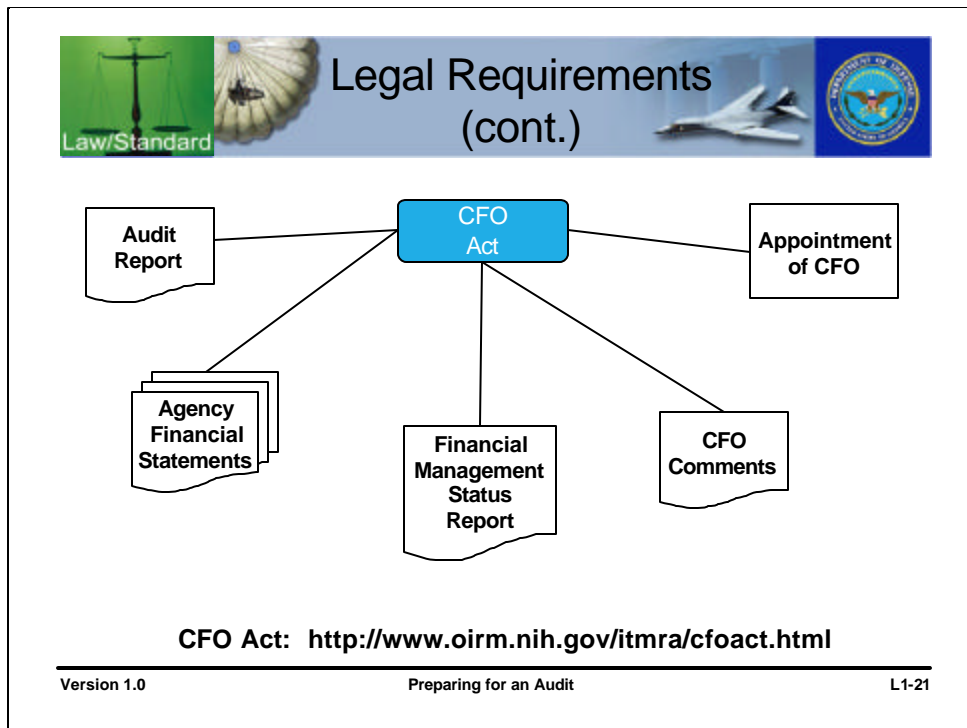
L1-20

In FY 2004, the Department took numerous steps to improve the Department-wide training, awareness, communication, and emphasis for full disclosure and prompt resolution of weaknesses. Beginning at mid-year in FY 2004, the Department began using an automated system to track and update the progress of corrective actions for reported weaknesses. Quarterly tracking has increased leadership's awareness of the importance the Department places on prompt resolution of reported weaknesses. A Management Control Program scorecard was also implemented to score the critical elements of Statement of Accountability (SOA) reporting: timeliness, format, program execution, training, and material weakness reporting.

This slide shows the planned milestones for FY 2005 corrective actions.

The DoD strongly encourages forthright reporting of material weaknesses in internal controls for all programs and operations important to the Department's mission.

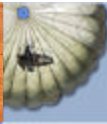
Now let's discuss the provisions of the CFOA of 1990.



The CFOA provides for a single source of accountability within each designated executive agency for the reporting of that agency's financial status. Within the DoD, it requires the establishment of an agency chief financial officer (CFO) at the Department level. Below the Department level, the services and agencies may have a chief financial executive (CFE) or other named financial manager to serve as their point of contact for financial reporting. The CFO and select CFEs prepare and submit an annual report to the agency head and the Director of OMB. That report includes the status of financial management, copies of the annual financial statements, the audit report, a summary of the reports on internal accounting and administrative control systems submitted to the President and Congress (under the FMFIA), and other information deemed appropriate.

The CFOA requires that each financial statement be audited in accordance with applicable Generally Accepted Government Auditing Standards (GAGAS). According to the 2004 DoD PAR, several of the Department's subordinate agencies have received a favorable audit opinion on their financial statements. However, to date, the DoD-wide statements have received a disclaimer of opinion from the auditors.

Let's consider some of the information reported on the financial statements.



Financial Statements



Financial Statements:

- **Balance Sheet**
- **Statement of Net Cost**
- **Statement of Changes in Net Position**
- **Statement of Budgetary Resources**
- **Statement of Financing**
- **Statement of Custodial Activity**
- **Notes to the financial statements**

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Preparing for an Audit

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You found that several pieces of legislation require the preparation of financial statements to meet the reporting objectives, comply with accounting standards, identify needed improvements, and account for the use of resources in the performance of the organizational mission.

The financial statements are a picture of the financial position of an entity as of a point in time. Various entities within the Department prepare financial statements that are consolidated quarterly. The DoD Consolidated Financial Statements as of the end of the fiscal year, September 30, are published in the annual PAR. The financial statements are preceded by Management Discussion and Analysis in which management provides an overview of the scope of their operations, provides a report on their internal controls and conformance to financial systems requirements, and discusses any issues that may be important to users of the financial statements. They are followed by required supplementary stewardship information and other required supplementary information. An extract of the financial statements contained in the 2004 DoD PAR is provided in Appendix C.

During an audit, amounts shown on the financial statements are verified through an examination of sample data and other evidence to ensure the reliability of the reported information. To better understand why an audit of the financial statements is important, let's consider the uses of the financial statements and the information they provide.



Financial Statements (cont.)



- Assets
- Liabilities
- Net Position
- Previous year comparison
- Refers to Notes

Department of Defense Agency Wide Consolidated Balance Sheet As of September 30, 2004 and 2003 (\$ in Millions)	2004 Consolidated	2003 Consolidated Restated
ASSETS (Note 2)		
Intra-governmental:		
Fund Balance with Treasury (Note 3)	\$ 287,685.5	\$ 251,544.1
???????	????????	????????
Total Intra-governmental Assets	\$ 522,798.8	\$ 458,609.6
Cash and Other Monetary Assets (Note 7)	2,178.1	1,534.9
Receivables???????	?????	??????
Inventory and Related Property (Note 9)	213,219.4	205,544.6
General Property, Plant and Equipment (Note 10)	440,898.6	446,308.9
?????	??????	??????
TOTAL ASSETS	\$ 1,208,486.2	\$ 1,141,309.3
LIABILITIES (Note 11)		
Intra-governmental:		
Accounts Payable (Note 12)	\$ 13,207.1	\$ 10,538.7
Mil Retirement/Emp-Related Actuarial (Note 17)	28,309.0	27,863.8
1,569,704.7	1,429,565.5	
??????	??????	??????
TOTAL LIABILITIES	\$ 1,710,113.6	\$ 1,559,638.5
NET POSITION		
Unexpended Appropriations (Note 18)	\$ 243,813.9	\$ 218,869.5
Cumulative Results of Operations	(745,441.3)	(637,198.7)
TOTAL NET POSITION	\$ (501,627.4)	\$ (418,329.2)
TOTAL LIABILITIES AND NET POSITION	\$ 1,208,486.2	\$ 1,141,309.3

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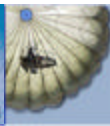
The Balance Sheet lists the assets, liabilities, and net position of the entity. Assets represent the value of items owned by an organization. These items of ownership are the resources the organization needs to accomplish its mission. Think about them with respect to the ownership of your home or car. Your assets are used to accomplish your family's mission.

Liabilities represent the amount an organization owes to its creditors. These items are the creditors' claims against the assets of the organization. You can draw parallels to your ownership of your home or car. Do you own them outright or do you have a loan where a creditor has a claim?

The Net Position represents the worth of the owners investment in an organization. These are the owner's claim against the assets of the organization. You can once again draw parallels to your ownership of your home or car. How much did you pay as a down payment? Has the property appreciated or depreciated in value due to improvements or increases in market value?

Management uses a Balance Sheet to compare the activity of their organization as represented by the amounts shown as assets, liabilities, and net position from one period to the next. They are interested in changes in amounts attributable to changes in known activity. Any changes to amounts that are not explained by changes in known activity are areas of concern for management as they may be a result of recording or reporting errors, fraud, or mismanagement.

Amounts shown on the Balance Sheet are comprised of several account balances or are the amounts transferred from related financial statements. Let's illustrate this by examining the asset Inventory and Related Property as detailed in Note 9, and the Cumulative Results of Operations, as shown on the Consolidated Statement of Changes in Net Position.



Financial Statements (cont.)



Notes to the Financial Statements

- Provide account detail
- Describe accounting methods
- Describe guidance that pertains to reported amounts

Note 9. Inventory and Related Property As of September 30, (\$ in Millions)				2004	2003
1. Inventory, Net				\$ 68,207.9	\$ 64,365.4
2. Operating Materials & Supplies, Net				143,489.7	139,351.2
3. Stockpile Materials, Net				1,521.8	1,828.0
4. Total				\$ 213,219.4	\$ 205,544.6

Inventory, Net As of September 30 (\$ in Millions)	Inventory, Gross Value	2004 Revaluation Allowance	Inventory, Net	2003 Inventory, Net	Valuation Method
1. Inventory					
A. Available and Purchased for Resale	\$ 75,931.7	\$(33,557.2)	\$42,374.5	\$42,216.0	LAC, MAC
B. Held for Repair	30,027.6	(5,369.7)	24,657.9	20,206.3	LAC, MAC
C. Excess, Obsolete, and Unserviceable	5,368.1	(5,368.1)	0.0	0.0	NRV
D. Raw Materials	21.3	0.0	21.3	9.8	MAC, SP, LAC
E. Work in Process	1,154.2	0.0	1,154.2	1,933.3	AC
F. Total	\$ 112,502.9	\$(44,295.0)	\$68,207.9	\$64,365.4	

Generally, there are no restrictions on the use, sale, or disposition of inventory except in the following situations:

- Distributions without reimbursement are made when authorized by DoD directives.
- War reserve material includes fuels and subsistence items that are considered restricted.
- Inventory, with the exception of safety stocks, may be sold to foreign, state...

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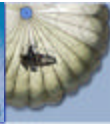
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Notes to the financial statements provide account detail for the amounts that are consolidated into the associated financial statement to which the note applies such as the balance sheet. These notes also describe accounting methods if applicable and describe guidance that pertains to the reported amounts.

Notice that the total (Item 4) of the Inventory and Related Property for the fiscal year 2004 is \$213,219.4 million. That amount is carried to the same titled line in the Assets section of the balance sheet. Also notice that the Inventory of Related Property is made up of three accounts. The first account, Inventory, Net is illustrated to show the method by which that amount was calculated and the method used to value the different categories of inventory. The Total of Inventory, Net for the year 2004 in the amount of \$68,207.9 million is carried from the calculated amount to the Inventory, Net (Line 1).

Management uses the notes to the financial statements to explain the account totals to users of the financial statements. Using this example, you can determine that if you have an inventory balance of goods that are available and purchased for resale, the appropriate valuation method is either Latest Acquisition Cost (LAC) or Moving Average Cost (MAC). You can also see the different categories of inventory and related property that you may be responsible for reporting.

Now let's examine the Cumulative Results of Operations as shown on the Consolidated Statement of Changes in Net Position.



Financial Statements (cont.)



Statement of Changes in Net Position

- Cumulative Results of Operations
- Adjustments
- Financing Sources
- Net Cost of Operations
- Total carried to the Balance Sheet

Department of Defense Agency Wide Consolidated Statement of Changes in Net Position For the periods ended September 30, 2004 and 2003 (\$ in Millions)	2004 Consolidated	2003 Consolidated Restated
CUMULATIVE RESULTS OF OPERATIONS		
Beginning Balances	\$ (621,610.7)	\$ (946,947.7)
Prior period adjustments (+/-)	<u>(15,588.0)</u>	<u>10,534.8</u>
Beginning Balance, Restated	(637,198.7)	(936,412.9)
Prior Period Adjustments -Not Restated (+/-)	699.5	383,074.9
Beginning Balances, as adjusted	(636,499.2)	(553,338.0)
Budgetary Financing Sources:		
Appropriations received	0.0	0.0
Appropriations transferred in/out (+/-)	0.0	0.0
??????	??????	??????
Other Financing Sources:		
Donations and forfeitures of property	0.4	4.6
Transfers -in/out without reimbursement (+/-)	(2,848.6)	(6,702.1)
??????	<u>??????</u>	<u>??????</u>
Total Financing Sources	\$ 496,422.8	\$ 428,429.9
Net Cost of Operations (+/-)	<u>605,364.9</u>	<u>512,290.6</u>
Ending Balances	<u>\$ (745,441.3)</u>	<u>\$ (637,198.7)</u>

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The purpose of the Statement of Changes in Net Position is to show the sources and application of funds during the year and the resulting change in net position.

Changes in net position, or ownership, are the result of the receipt of spending authority as represented by appropriations received or transferred, and through other sources of financing, and are the result of the cost of operations. The resulting balance of \$745,441.3 million is transferred to the Balance Sheet in the Net Position line titled Cumulative Results of Operations.

The Net Cost of Operations of \$605,364.9 million was transferred from the Consolidated Statement of Net Cost, and the Combined Statement of Financing provided information included in the Other Financing Sources lines. Let's look at the Consolidated Statement of Net Cost.



Financial Statements (cont.)



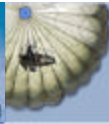
Statement of Net Cost

- Program Costs
- Net Cost of Operations
- Total carried to the Statement of Changes in Net Position

Department of Defense Agency Wide Consolidated Statement of Net Cost For the periods ended September 30, 2004 and 2003 (\$ in Millions)	2004 Consolidated	2003 Consolidated
PROGRAM COSTS		
Intra-governmental Gross Costs	\$ 23,574.5	\$ 11,748.3
(Less: Intra-governmental Earned Revenue)	(15,429.0)	(11,239.0)
Intra-governmental Net Costs	8,145.5	(1,490.7)
Gross Costs With the Public	619,573.8	526,288.4
(Less: Earned Revenue From the Public)	(22,354.4)	(12,207.1)
Net Costs With the Public	\$ 597,219.4	\$ 513,781.3
Total Net Cost	605,364.9	512,290.6
Cost Not Assigned to Programs	0.0	0.0
(Less: Earned Revenue Not Attributable to Programs)	0.0	0.0
Net Cost of Operations	\$ 605,364.9	\$ 512,290.6

The Statement of Net Costs is designed to show the components of the net cost for the entity's operations for the period. Costs are separated by whether they are within the government or with the public. It is important that the source of costs are identified to ensure that only one reporting entity reports each identified cost. Intra-governmental eliminations are explained in Lesson 2 of this course.

The Net Cost of Operations is the total cost incurred by the organization less any earned revenue from its activities. The total cost of a program consists of the direct cost of the outputs produced by that program plus any indirect and administrative costs that can be assigned to the program. The Net Cost of Operations was transferred to the Statement of Changes in Net Position.



Financial Statements (cont.)



Statement of Budgetary Resources

- Budget and Spending Authority and Restrictions on Funds

Department of Defense Agency Wide Combined Statement of Budgetary Resources For the periods ended September 30, 2004 and 2003 (\$ in Millions)	2004 Combined	2003 Combined
Budgetary Financing Accounts Budgetary Resources		
Budget Authority...		
Un-obligated balance:		
Spending Authority...		
Earned:		
Collected		
Receivable..		
Change in unfilled customer orders		
Advance received		
Without advance...		
Anticipated for the rest of the year, without advances		
Recoveries		
Temporary not available		
Permanently not available		
Total Budgetary Resources	\$1,014,657.3	\$ 928,751.7

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The Statement of Budgetary Resources illustrates the differences between Budget Authority and Spending Authority. Budget Authority is comprised of appropriations received, borrowing authority, contract authority, and transfers. Spending authority is from offsetting collections.

Earned authority, as a segment of spending authority, is either collected or receivable from federal sources. Spending authority may also be in the form of a change in unfilled customer orders either with or without advances.

The Statement of Budgetary Resources also shows amounts that are not available either temporarily pursuant to public law, or permanently.

Now let's discuss the Statement of Financing.



Financial Statements (cont.)



Statement of Financing

- **Resources Used to Finance Activities**

Department of Defense Agency Wide Combined Statement of Financing For the periods ended September 30, 2004 and 2003 (\$ in Millions)	2004 Combined	2003 Combined
Resources Used to Finance Activities		
Budgetary Resources Obligated...		
Other Resources...		
Total resources used to finance activities		
Resources Used to Finance Items not Part of the Net Cost of Operations...		
Total resources used to finance the net cost of operations	<u>\$ 397,698.4</u>	<u>\$ 362,794.1</u>

The Statement of Financing is used to explain the resources used to finance the activities of the Department. It separates resources by those used to finance activities, and those used to finance items that are not part of the net cost of operations, with a resultant total of the resources used to finance the net cost of operations.

Let's continue with the Statement of Custodial Activity.



Financial Statements (cont.)



Statement of Custodial Activity

- **Source and Disposition of Collections on Behalf of Others**

Department of Defense Agency Wide Combined Statement of Custodial Activity For the periods ended September 30, 2004 and 2003 (\$ in Millions)	2004 Combined	2003 Combined
Source of Collections:		
Deposits by Foreign Governments	\$ 11,237.5	\$ 9,971.6
Seized Iraqi Cash	118.3	808.9
Other Collections..	?????	?????
Total Custodial Collections	<u>\$ 11,356.7</u>	<u>\$ 10,781.2</u>
Disposition of Collections		
Disbursed on Behalf of Foreign Governments and International Organizations	\$ 9,998.8	\$ 10,118.8
Seized Assets Disbursed on Behalf of Iraqi People	283.1	530.8
Collections Used for Refunds and Other Payments	?????	?????
Retained by The Reporting Entity		
Seized Assets Retained...		
Total Disposition of Collections	<u>\$ 11,356.7</u>	<u>\$ 10,781.2</u>
Net Custodial Collection Activity	<u>0.0</u>	<u>0.0</u>

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The Statement of Custodial Activity reports on the sources and disposition of collections on behalf of others. Notice that the Total Custodial Collections should equal the Total Disposition of Collections with a resultant balance in the Net Custodial Collection Activity of \$0.0.

Now that you are familiar with the financial statements, let's discuss the regulatory requirements for their preparation, and for the audit of the financial statements and supporting systems and controls.



Compliance with Regulatory Requirements

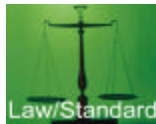


Regulatory requirements for the application of accounting standards, reporting, internal control, and accountability:

- **OMB Guidance**
- **Treasury Financial Manual (TFM)**
- **DoD 7000.14-R, Financial Management Regulation (DoDFMR)**

Compliance with legal and regulatory requirements is one of the first items checked in an audit of an organization. The requirement for the preparation and audit of the DoD financial statements and the results of operations are embedded within this guidance.

Let's begin with a discussion of the OMB guidance.



Compliance (cont.)



Office of Management and Budget (OMB) Guidance

- **OMB Bulletin 01-09, Form and Content of Agency Financial Statements**
- **OMB Bulletin 01-02, Audit Requirements for Federal Financial Statements**
- **OMB Circular A-123, Management Responsibility for Internal Control**
- **OMB Circular A-127, Financial Management Systems**

OMB: <http://www.whitehouse.gov/omb>

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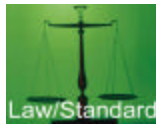
OMB Bulletin 01-09, Form and Content of Agency Financial Statements, provides guidance for preparing agency financial statements and is intended to move federal agencies toward producing timely, reliable financial information to measure and affect performance in a real-time environment. It accelerates reporting due dates and requires interim financial reporting, comparative reporting, budget integration, and integrated reporting. Integrated reporting involves both performance and accountability reports. In addition, this bulletin addresses financial statement format. This involves improvements to labeling and formatting of line items to facilitate an understanding of the flow of information between statements.

OMB Bulletin 01-02, Audit Requirements for Federal Financial Statements, establishes minimum requirements for the audit of federal financial statements. It assigns responsibility for audits of financial statements to the Inspector General of the executive department or agency. It discusses communication between agency management, including the CFO, and the Inspector General, and it discusses the scope of the audit and resultant reports, management schedules and letters, agreed-upon procedures, and Inspector General oversight.

OMB Circular A-123, Management's Responsibility for Internal Control, requires agencies and individual federal managers to take systematic and proactive measures to develop and implement appropriate, cost-effective management controls; assess the adequacy of internal control in federal programs and operations; separately assess and document internal control over financial reporting consistent with the process; identify needed improvements; take corresponding corrective action; and report annually on internal control through management assurance statements.

OMB Circular A-127, Financial Management Systems prescribes policies and standards for executive departments and agencies to follow in developing, operating, evaluating, and reporting on financial management systems.

Now let's discuss the provisions of Volume 1 of the TFM.



Compliance (cont.)



Treasury Financial Manual (TFM)

The Department of the Treasury's official publication for financial accounting and reporting of all receipts and disbursements of the federal government



- **Six volumes**
- **Volume 1, Part 2, Central Accounting and Reporting, contains requirements for the form, content, and submission of financial data**

TFM: <http://www.fms.treas.gov/tfm>

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The TFM is the Department of the Treasury's official publication for financial accounting and reporting of all receipts and disbursements of the federal government. It is divided into six volumes. Volume 1 of the TFM applies to all federal agencies and contains instructions in the areas of central accounting and reporting, payrolls, deductions and withholdings, disbursing, deposit regulations, and other fiscal matters. It is organized in six parts: Part 1, Introduction; Part 2, Central Accounting and Reporting; Part 3, Payrolls, Deductions, and Withholdings; Part 4, Disbursing; Part 5, Deposit Regulations; and Part 6, Other Fiscal Matters.

We are particularly interested in Part 2, Central Accounting and Reporting. This part contains requirements for the form, content, and submission of financial data required by the Financial Management Service (FMS) to fulfill its central accounting and reporting obligations for the financial operations of the federal government.

Now let's examine the requirements of the DoDFMR and how they affect financial statement reporting.



Compliance (cont.)



DoD Financial Management Regulation (DoDFMR)

Provides procedural guidance to be used in day-to-day operations in order to comply with reporting rules.

- 15 volumes
- Volume 6, Reporting Policy and Procedures
- Volume 6a provides detailed guidance on required report forms and formats
- Volume 6b describes the format, responsibility, and standards of defense agency financial statements, and the various DoD reporting entities
- Quarterly updates are available and should be consulted



DoDFMR: <http://www.dod.mil/comptroller/fmr/>

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The DoD 7000.14-R, Financial Management Regulation, or DoDFMR, provides policy, regulation, and procedural guidance to be used in day-to-day operations in order to comply with reporting rules. It consists of 15 volumes on numerous subjects within the area of responsibility of the Comptroller of DoD. In discussing the requirement for reporting, we are particularly interested in Volume 6, Reporting Policy and Procedures. This volume is divided into two parts. The first part is Volume 6a, Reporting Policy and Procedures, and the second part is Volume 6b, Form and Content of the DoD Audited Financial Statements.

Volume 6a provides detailed guidance on required report forms and formats. Volume 6b describes the format, responsibility, and standards of defense agency financial statements, and the various DoD reporting entities. This volume also discusses performance measures, financial statement analysis, and special reports.

Volume 6b, Form and Content of the DoD Audited Financial Statements, begins by stating the requirement for audited financial statements of the DoD, and for separate audited financial statements for several individual reporting entities. It describes the content of the five major sections of the audited financial statements and the order of their presentation. It then provides instructions for each of the financial statements, including the responsibilities for their preparation. It defines the line items on the financial statements, and provides format, content, and instruction for the preparation and presentation of worksheets in support of eliminations. Key components of financial statements are discussed in the next lesson.

It is important to note that quarterly guidance that provides reporting updates for financial statements should also be consulted and that reports in the Defense Department Reporting System (DDRS) are often updated quicker than the DoDFMR. Now that we've discussed the legal and regulatory requirements that lead to the audit of the DoD financial statements and results of operations, let's discuss the audit agencies.



Federal Government Auditing Entities



Government Accountability Office (GAO)

- **Evaluates policies and programs**
- **Publishes Government Auditing Standards (Yellow Book) and the GAO/PCIE Financial Audit Manual (FAM)**

Department of Defense Inspector General (DoDIG)

- **Internal audit agency of the DoD**
- **Responsible for financial statement audits of all DoD entities**

Other audit agencies

- **Army Audit Agency**
- **Air Force Audit Agency**
- **Naval Audit Service**
- **Entity Inspector Generals**

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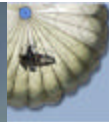
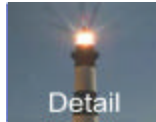
L1-34

There are several federal government auditing entities. The DoD community is primarily concerned with the U.S. Government Accountability Office (GAO), the DoDIG, and the services' audit agencies.

The GAO is an independent, nonpartisan agency that works for Congress. GAO is often called the “congressional watchdog” because it investigates how the federal government spends taxpayer dollars. GAO supports congressional oversight by evaluating how well government policies and programs are working; auditing agency operations to determine whether federal funds are being spent efficiently, effectively, and appropriately; investigating allegations of illegal and improper activities; and issuing legal decisions and opinions.

In preparing for an audit, the Government Auditing Standards (Yellow Book) and the GAO/PCIE FAM are valuable references. These references are covered in Lesson 2 of this course.

Now let's look at the role of the DoDIG.



Auditing Entities (cont.)



Typical DoDIG Audit Customers

Army O&M	Defense Commissary Agency
Army WCF	Defense Contract Audit Agency
Navy O&M	Defense Health Program – Air
Navy WCF	Force
Marine Corps O&M	Defense Health Program – Army
Air Force O&M	Defense Logistics Agency (DLA)
Air Force WCF	
Corps of Engineers – Army	
Defense Contract	
Management Activity	And several others

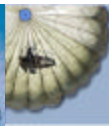
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The DoDIG is the internal audit agency of the DoD and is responsible for financial statement audits of all DoD entities. The DoDIG is the principal adviser to the Secretary of Defense for matters relating to the prevention of fraud, waste, and abuse in the programs and operations of the Department. In carrying out all of the other statutory duties, the DoDIG is obligated by law to give particular regard to the activities of the internal audit, inspection, and investigative units of the military departments with a view towards avoiding duplication and ensuring effective coordination and cooperation.

Taking into consideration the cost of audits avoiding duplication is a major concern. Let's look at some of the services provided by other audit agencies.



Auditing Entities (cont.)



Other Audit Agencies:

- **Army Audit Agency**
- **Air Force Audit Agency**
- **Naval Audit Service**
- **Entity Inspector Generals**



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Other audit agencies include the Army Audit Agency, the Air Force Audit Agency, and the Naval Audit Service. Entities within the Department are also represented by their internal Inspector Generals. They are responsible for various types of audits and services in support of their service organizations and affiliates, other than financial statement audits.

The Army Audit Agency is headquartered in Alexandria, VA, and has 23 field offices, 20 in the Continental United States and 3 overseas (Republic of Korea, Hawaii, and Europe). This agency performs Acquisition and Logistics Audits, Forces and Financial Audits, and Policy and Operations Management. Among their notable products are Benford's Law Excel Macros that help detect irregularities in statistical, numerical data; a statistical sampling program; and a financial analysis program that performs various financial analyses.

The Air Force Audit Agency's centrally directed audits provide Air Force-wide evaluations that primarily serve Headquarters Air Force and major commands, and are performed by either the Financial and Support Audits Directorate or Materiel and Systems Audits Directorate. Their installation-level audits address base-level issues at a single location. The Air Force Audit Agency's Commander's Audit Program addresses a specific area of concern and provides limited distribution of the audit results unless the report discloses fraud or violations of public law. This agency also provides training on how to establish and maintain an effective internal control structure, including preventive and detective controls.

The Naval Audit Service is responsible for internal audit of the Department of the Navy. The Naval Audit Service provides independent, professional internal audit services that assist Naval leadership in improving efficiency, accountability, and program effectiveness. It accomplishes this by performing internal audits of Department of the Navy organizations, programs, activities, systems, functions, and funds. These audits are to evaluate whether the Department of the Navy information is reliable; resources have been safeguarded; funds have been expended consistent with laws, regulations, and policies; resources have been managed economically and efficiently; and desired program performance has been achieved. The Central Office of the Naval Audit Service is in the Washington Navy Yard, Washington, D.C. The Audit Service has area offices in Virginia Beach, VA, and San Diego, CA.

Each of these agencies is required to comply with applicable guidance in the performance of, and resulting reporting on, audits of government entities. Let's examine this guidance.



Applicable Guidance



Generally Accepted Accounting Principles (GAAP) -

Accounting rules used to prepare financial statements for publicly traded companies and many private companies in the United States. The four basic principles are:



- *Historical cost principle* requires companies to account and report based on acquisition costs rather than fair market value for most assets and liabilities.
- *Revenue recognition principle* requires revenue to be recorded when it is realized or realizable and earned, not when cash is received. (accrual-basis accounting)
- *Matching principle* requires that expenses be matched with revenues as long as it is reasonable doing so.
- *Full disclosure principle* requires that amounts and kinds of information disclosed should be decided based on trade-off analysis as a larger amount of information costs more to prepare and use.

FASB GAAP: <http://www.fasb.org>

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The mission of the Financial Accounting Standards Board (FASAB) is to establish and improve standards of financial accounting and reporting for the guidance and education of the public, including issuers, auditors, and users of financial information. Generally Accepted Accounting Principles (GAAP) are the accounting rules used to prepare financial statements for publicly traded companies and many private companies in the United States. GAAP are not written in law, although the Securities and Exchange Commission (SEC) requires that they be followed in financial reporting by publicly traded companies.

The American Institute of Certified Public Accountants (AICPA) Code of Professional Conduct prohibits members from expressing an opinion or stating affirmatively that financial statements or other financial data "present fairly...in conformity with GAAP," if such information contains any departures from accounting principles promulgated by a body designated by the AICPA Council to establish such principles. GAAP has four basic principles:

- The historical cost principle requires companies to account and report based on acquisition costs rather than fair market value for most assets and liabilities.
- The revenue recognition principle requires revenue to be recorded when it is realized or realizable and earned, not when cash is received. This way of accounting is called accrual-basis accounting.
- The matching principle requires that expenses be matched with revenues as long as it is reasonable doing so.
- The full disclosure principle requires that amounts and kinds of information disclosed should be decided based on trade-off analysis as a larger amount of information costs more to prepare and use. Information disclosed should be enough to make judgments while keeping costs reasonable.

FASAB is the body that establishes accounting principles for federal entities. Let's discuss this entity next.



Applicable Guidance (cont.)



Financial Accounting Standards Advisory Board (FASAB)

Mission is to promulgate federal accounting standards based on the needs of users of federal financial information. The four FASAB Statements of Federal Financial Accounting Concepts are:

- **Objectives of Federal Financial Reporting**
- **Entity and Display**
- **Management's Discussion and Analysis**
- **Intended Target Audience and Qualitative Characteristics for the Consolidated Financial Report of the United States Government.**

FASAB Standards and Concepts: <http://www.financenet.gov/fasab.htm>

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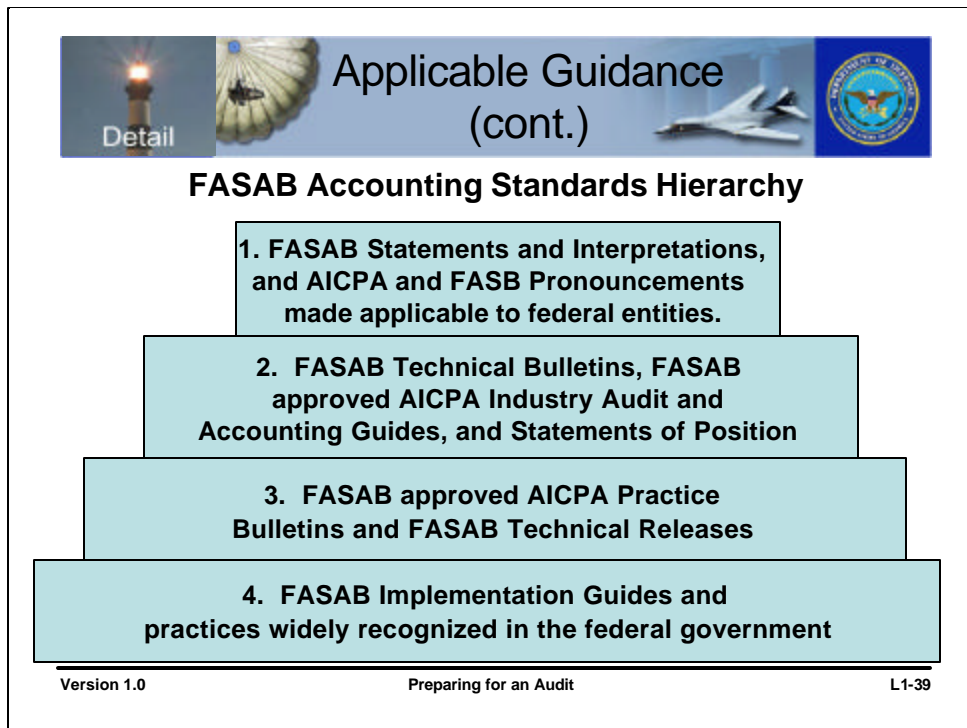
L1-38

The mission of the FASAB is to promulgate federal accounting standards based on the needs of users of federal financial information. Federal government entities must follow federal accounting and financial reporting standards in fulfilling the government's duty to be publicly accountable.

There are four FASAB Statements of Federal Financial Accounting Concepts and 25 Statements of Federal Financial Accounting Standards issued by the FASAB. Statements on concepts are more general than statements of standards and do not contain specific recommendations that are authoritative requirements for federal agencies and auditors. The standards are intended to be definitive accounting and reporting guidance to federal agencies.

The four concepts are: Objectives of Federal Financial Reporting, Entity and Display, Management's Discussion and Analysis, and Intended Target Audience and Qualitative Characteristics for the Consolidated Financial Report of the United States Government.

The Entity and Display concept is intended to provide guidance as to what would be encompassed by a federal government entity's financial report. It is useful to the OMB, when OMB specifies what entity should prepare financial statements and the form and content of those statements pursuant to authority assigned in the CFOA.



As stated earlier, FASAB promulgates accounting standards for U.S. government reporting entities. This hierarchy lists the priority sequence of sources that an entity should look to for accounting and reporting guidance.

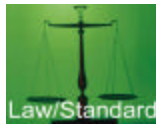
The first category of federal GAAP is FASAB Statements and Interpretations, and AICPA and FASAB pronouncements specifically made applicable to federal governmental entities by FASAB statements or interpretations.

The next category consists of FASAB Technical Bulletins and, if specifically made applicable to federal governmental entities by the AICPA and cleared by the FASAB, AICPA Industry Audit and Accounting Guides and AICPA Statements of Position.

The third category consists of AICPA Accounting Standards Executive Committee (AcSEC) Practice Bulletins specifically made applicable to federal governmental entities and cleared by the FASAB, as well as Technical Releases of the Accounting and Auditing Policy Committee of the FASAB.

Finally, the last category includes implementation guides published by the FASAB staff, as well as practices that are widely recognized and prevalent in the federal government.

Now that we've examined the accounting standards, let's look at the hierarchy of the auditing standards.



Applicable Guidance (cont.)



Generally Accepted Auditing Standards (GAAS) and Generally Accepted Government Auditing Standards (GAGAS)

- **GAAS include the general standards, standards of field work, and reporting standards. GAAS is applicable to all audits.**
- **GAGAS contain standards for audits of government organizations, programs, activities, and functions as well as government assistance received by contractors, not-for-profit organizations, and other nongovernmental organizations.**

GAAS include the general standards, standards of field work, and reporting standards. GAAS is applicable to all audits.

GAGAS contain standards for audits of government organizations, programs, activities, and functions as well as government assistance received by contractors, not-for-profit organizations, and other nongovernmental organizations.

For financial statement audits, GAGAS prescribes fieldwork and reporting standards beyond those required by GAAS. The GAO Yellow Book, discussed in Lesson 2, incorporates both GAAS and GAGAS.

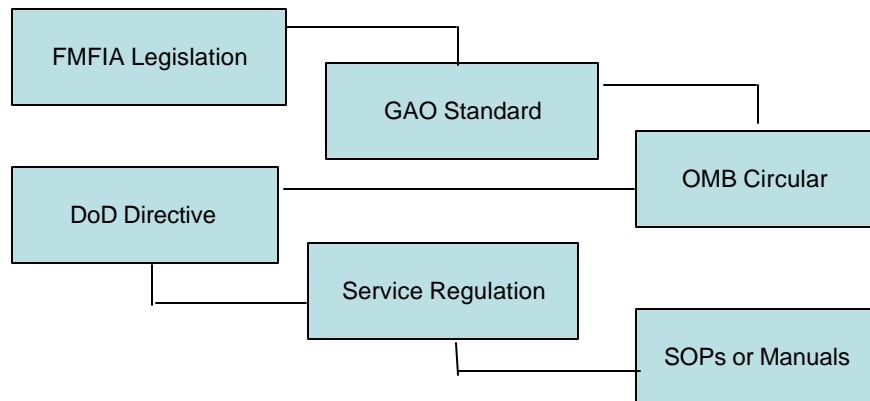
For every requirement at the highest level of authority in an organization, there is an agency-specific requirement that interprets, assigns responsibility, or provides instruction to succeeding levels of the organization. Let's examine a few.



Applicable Guidance (cont.)



Example of Legislative and Regulatory Requirements



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Based on the requirement to implement internal control in government outlined in the FMFIA, the GAO issued standards for internal control in GAO/AIMD-00-21.3.1, Standards for Internal Control in the Federal Government. Parallel to the GAO guidance, OMB issued Circular A-123, Management Accountability and Control.

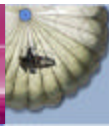
Under the same guidance, and citing OMB Circular A-123 as well as GAO Standards for Internal Control in the Federal Government, the DoD issued DoD Directive 5010.38, Management Control Program. In addition to this directive, specific guidance in the form of an OSD policy memorandum was issued concerning Internal Controls for the Purchase Card Program. Such policy memorandums are used to focus attention on a particular issue, rule, or situation that may or may not be clearly stated in the directive. A policy memorandum may add to the requirement, but may not take away from the requirement.

A regulation assigns responsibility, provides policy, and states requirements. It provides an overview of the applicable subject and provides reference to the source of the requirements contained within the document. Army Regulation (AR) 11-2, Management Control, is a typical example. The regulation implements public law, OMB, and DoD guidance by prescribing policies and guidance for the Army management control process. It applies to commanders and managers at all levels of the Army. It contains management control provisions and provides evaluation criteria for use in evaluating management controls. As an example of how this regulation is applied, AR 95-1, Flight Regulations, provides guidance on implementing internal management controls per AR 11-2 to the Army aviation community through the use of applicable aviation controls.

Standard Operating Procedures (SOPs) are specific, detailed instructions on a group of requirements that affect a particular operating environment. Managers at the operating level incorporate the regulatory provisions within their SOPs. They may also maintain authorizations or certifications that include signature authority, professional certification, legal authority, position of authority, rank, grade, or other established authority.

Manuals also provide instruction on tasks required by regulations. They include, but are not limited to, training manuals, technical manuals, field manuals, supplements, circulars, or instructions.

Let's summarize what we learned in this lesson.



Lesson Summary



- **Types, purpose, and value of audits**
- **Common auditing terms**
- **Legal and regulatory requirements**
- **Financial Statements**
- **Auditing entities**
- **Applicable guidance**

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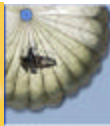
L1-42

In this lesson, you learned that financial statement audits report on whether or not an entity's financial reports fairly reflect the true financial position of that entity as of a particular point in time. You found that we audit because it's the responsibility of the government to its citizens to ensure that trust, and because better and more reliable information means better decisions by the Department's leadership at all levels.

In discussing common auditing terminology, you found that an unqualified opinion is the most preferred finding. An unqualified opinion is without any material exception to a general statement of reliability of the items specified within the limits of the audit. We then discussed legislation such as the Federal Financial Management Improvement Act, the Federal Managers' Financial Integrity Act, Inspector General Act, the Chief Financial Officers Act. We discussed the form and content of the Department financial statements and their usage. We then discussed the regulatory requirements for their preparation, and for the audit of the financial statements and supporting systems and controls.

You learned that there are several federal government auditing entities, including the GAO, the DoDIG, and the other audit agencies. You found that the FASAB, governs what constitutes accounting standards for U.S. government reporting entities, and that the first category is FASAB Statements and Interpretations, and AICPA and FASB pronouncements made applicable to federal entities. In addition, you found that for every requirement at the highest level of authority in an organization, there is an agency-specific requirement that interprets, assigns responsibility, or provides instruction to succeeding levels of the organization.

The following slides list references available for additional information.



References



PAR: <http://www.defenselink.mil/comptroller/par/>

FFMIA: <http://www.ignet.gov/pande/faec/gaoffmia.pdf>

FMFIA: <http://www.whitehouse.gov/omb/financial/print/fmfia1982.html>

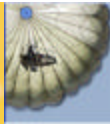
Inspector General Act:
<http://uscode.house.gov/uscode-cgi/fastweb.exe>

CFOA: <http://www.woirm.nih.gov/itmra/cfoact.html>

TFM: <http://fms.treas.gov/tfm>

DoDFMR: <http://www.dod.mil/comptroller/fmr/>

OMB Circular No.s A-123, and A-127:
<http://www.whitehouse.gov/omb/circulars/>



References (cont.)



OMB Bulletin No.s 01-09, and 01-02:
<http://www.whitehouse.gov/omb/bulletins/>

GAO: <http://www.gao.gov>

FASB GAAP: <http://www.fasb.org>

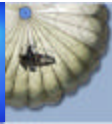
DoDIG: <http://www.dodig.osd.mil>

Army Audit Agency: <http://www.hqda.army.mil/aaaweb/>

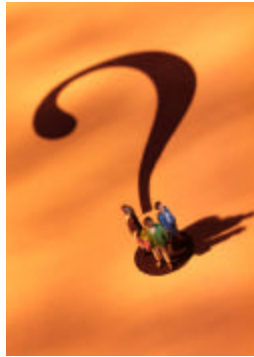
Air Force Audit Agency: <http://www.affaa.hq.af.mil/>

Naval Audit Service: <http://www.hq.navy.mil/NavalAudit/>

FASAB Standards and Concepts: <http://www.financenet.gov/fasab.htm>



Questions

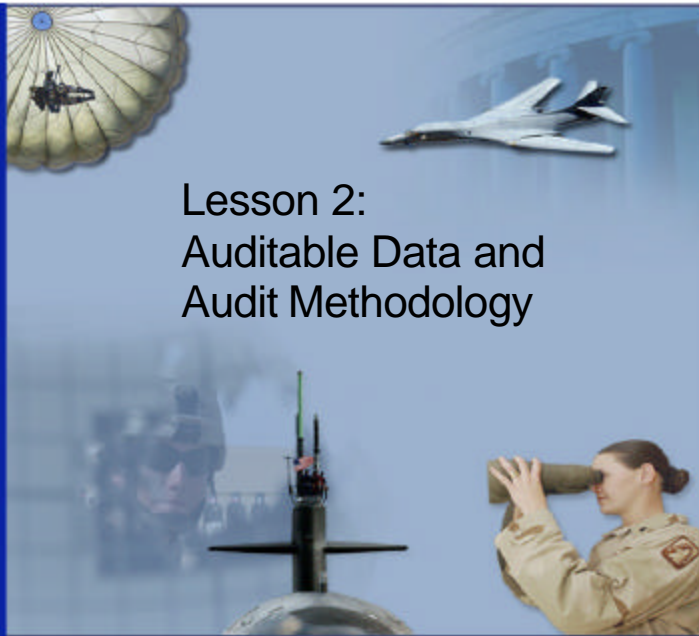


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Preparing for an Audit



Lesson 2: Auditable Data and Audit Methodology



In Lesson 2, we explore the federal government audit methodology and the information that flows between the various systems, that ultimately affects the financial statements.



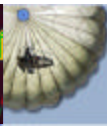
Lesson Objectives



Upon successful completion of this lesson, you will be able to:

- **identify the various feeder and accounting systems that impact the financial statements**
- **describe how to document the flow of agency information into the financial statements**
- **define a federal government audit**
- **explain the government audit methodology**
- **explain the importance of on-going communication.**

This lesson explains how the various feeder systems affect the financial statements, how the data on these systems is linked, and how the data is linked to the financial statements. We also discuss how to document that data which flows between agencies and ultimately to the financial statements. We then define a federal government audit and the methodology used to initiate and conduct it, and the importance of on-going communications in the Department and with the auditors.



Lesson Topics



This lesson contains the following topics:

- **Feeder & Accounting Systems**
- **Effect of Intragovernmental Transactions**
- **Effect of Accuracy on Statements on Decision-making**
- **Sources of Input**
- **Day-to-Day Operations/Information**
- **Financial Audit Manual (FAM) Checklist**

This lesson contains the following topics. Feeder and Accounting Systems discusses the auditors role in testing the accuracy of the information flow between feeder and accounting systems. We discuss intragovernmental transactions and the importance of making elimination entries. Effect of Accuracy on Statements on Decision-making discusses the role that the audit process plays in ensuring the validity of financial information. Sources of Input looks at those items in your day-to-day activities that play an important role in the process of providing an auditable trail for testing the validity of financial statements. Day-to-Day Operations/Information stresses the importance of doing the job right the first time so that rework is not necessary. The FAM Checklist provides auditors with a road map to a successful audit.



Lesson Topics (cont.)

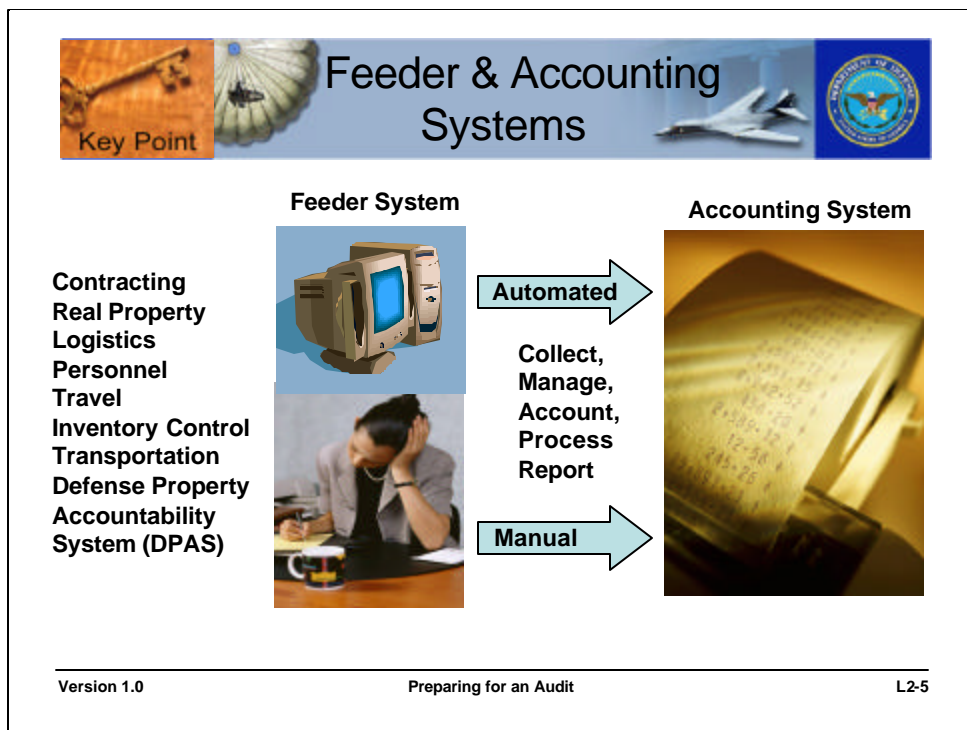


In addition, this lesson contains the following topics:

- **General Accountability Office**
- **Planning**
- **Internal Controls**
- **Testing**
- **Communications**

GAO publishes key guidance for auditing. Three of the phases of the audit process are described relative to the auditors' activities. They are Planning, Internal Controls, and Testing. The final topic, Communications, looks at the importance of the interaction between auditor and auditable entity prior to, during, and after the audit.

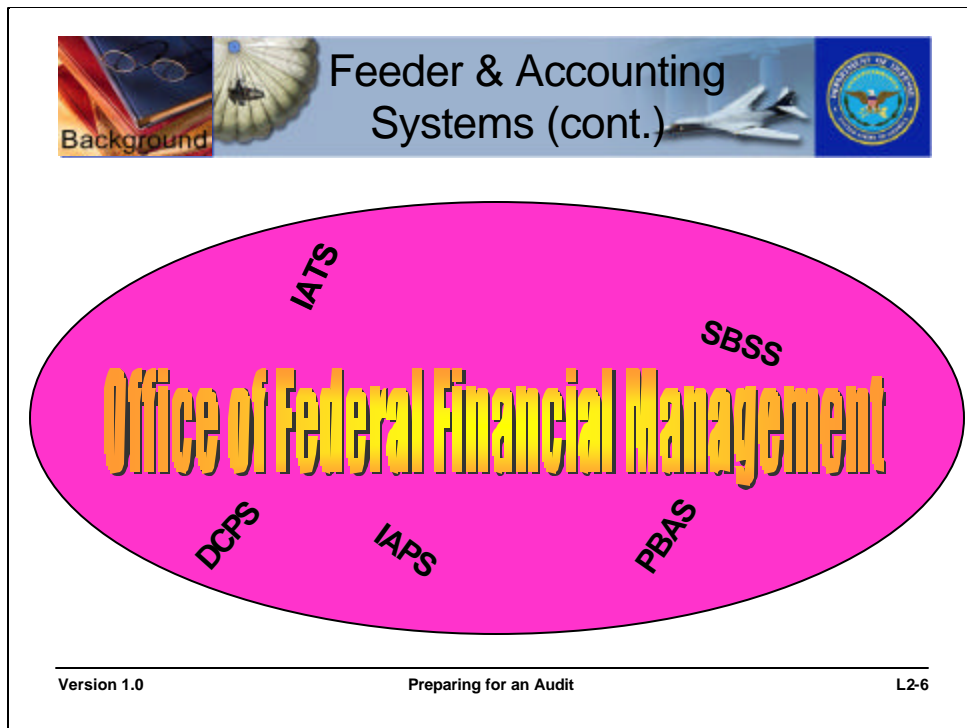
Let's begin with Feeder and Accounting Systems.



In this topic, you are exposed to how information flows from the feeder systems to the accounting system and then to the financial statements. Let's start out by first defining a feeder system. A feeder system is a system that is used to collect, manage, account, and process information for a specific function. The system may be a manual or automated process. It may be a managerial system that supports a function such as contracting, real property, logistics, personnel, travel, inventory control, transportation, or Defense Property Accountability System (DPAS). These systems produce financial information that is entered into the accounting system. Some systems such as the Department of the Navy Real Property System are considered non feeder systems. Non feeder systems such as these contribute data into reporting without becoming part of the accounting system. Now let's talk about accounting systems.

All the services and DoD have their own automated general ledger accounting systems. General ledger systems use the USSGL or the General Ledger Account Codes (GLAC) chart of accounts to summarize accounting transactions. An auditor would be interested in all processes that you employ, manual or automated, that could affect the reliability of the information that is passed from the feeder system to the accounting system. The auditor looks for problems that are the result of differences in automated systems and documentation.

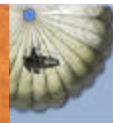
Let's discuss the Office of Federal Financial Management (OFFM) so that we understand their role in financial management practices.



The mission of the OFFM is to promote and support financial management in the executive branch of the Federal Government. The OFFM was created within the OMB by the CFOA of 1990. OFFM, led by the OMB Controller under the direction of the Deputy Director for Management, is responsible for the financial management by enlisting the joint cooperation of governmental organizations such as the GAO, Department of the Treasury, Office of Personnel Management (OPM), and federal agencies. OFFM responsibilities include implementing the financial management improvement priorities of the President, establishing government-wide financial management policies of executive agencies, and carrying out the financial management functions of the CFO Act.

OFFM provides a clearinghouse for sharing and disseminating information about good financial management techniques and practices. The improvement of financial management practices is important to you, as it provides federal agencies with the tools to build financial systems that deliver complete, consistent, reliable, and timely information that is crucial to decision-making processes. The issues that exist with feeder systems are that much of the data is not under adequate internal control and does not comply with the law. Therefore, the Department has embarked on an effort to bring its critical feeder systems into compliance with applicable federal requirements.

Now that we discussed the OFFM, let's look at how intragovernmental transactions and elimination play such a large role in the accuracy of financial statements.



Effect of Intragovernmental Transactions



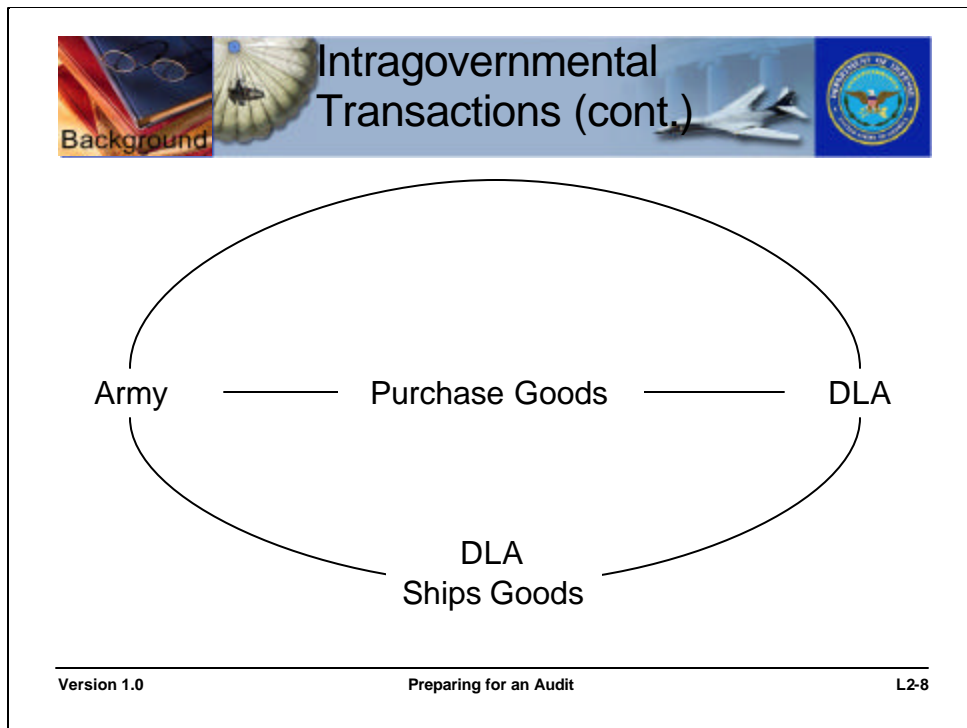
Intragovernment. Buy/sell examples:

- Interfund Purchases
- International Merchant Purchase Authorization Card (IMPAC) purchases from federal sources
- General Services Agency (GSA) supply card purchases
- GSA vehicle and space rental
- Transportation purchased from US Transportation Command (USTRANSCOM), including those billed directly from USTRANSCOM or via PowerTrack
- Supplies/services provided under Military Interdepartmental Purchase Request (MIPR) accepted category I (reimbursable)
- Services provided under Inter/Intra-service Support Agreements

Transfer examples:

- Assets transferred between federal partners (with or without resources)
- Appropriation and Non-expenditure transfers

Various entities within the Department prepare financial statements that are consolidated quarterly. The consolidated financial statements include all the agencies and organizations of the DoD. As a part of preparing the consolidated financial statements, a process called eliminations is performed. Eliminations addresses those entries that create misstatements in financial statements as a result of the government doing business with the government. We call these transactions intragovernmental. These misstatements, if not eliminated, would have the effect of overstating assets, liabilities, revenues, and expenses.



The main thing to consider when dealing with intragovernmental transactions (IGTs) is that they have reciprocal categories. Reciprocal categories are pairs of related USSGL accounts that must be used to reconcile and eliminate like IGT. Examples of reciprocal categories are:

- Revenues/Expenses (and Capitalized Assets)
- Accounts Receivable/Accounts Payable
- Transfers In/Transfers Out

An example of an intragovernmental transaction is an Army purchase from the DLA. DLA has earned a right to a reimbursement and has an accounts receivable. Army has goods but has not yet paid for them and therefore has an accounts payable. In this case there is no distortion as there is a reciprocal accounts receivable and accounts payable. If the Army were to pay for the goods eliminating the accounts payable and DLA has not yet recorded the payment to liquidate the accounts receivable, then the reciprocal accounts have not been balanced. The practice in the government in the past was to process an adjustment rather than find the reciprocal category causing misstatements. If this practice has been followed to any material extent then it would affect the audit.

Eliminations of IGTs are applied to sales from the government to itself. When items are bought and sold within the government they must not be recorded as a sale. These are merely a transfer of an asset and to consider them sales would only cause an overstatement of true sales.



Intragovernmental Transactions (cont.)



Trading Partners are the buyers and sellers and are categorized at six levels. The six levels are:

Level 1 – DoD to GSA

Level 2 – Between DoD reporting entities

Level 3 – Within department reporting entity

Level 4 – Between DoD agencies

Level 5 – Between entities of one agency

Level 6 – Within an entity

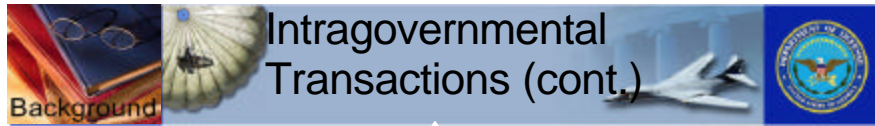
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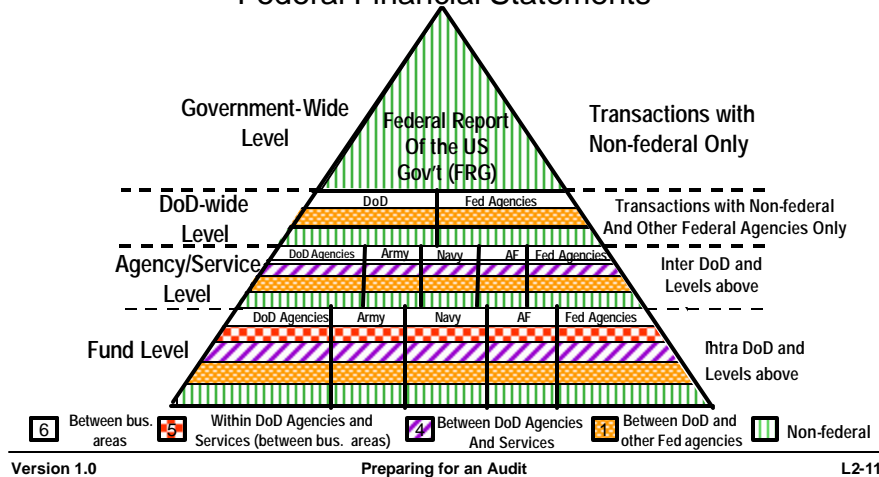
L2-9

Eliminations consider that a significant dollar volume of IGTs must be reconciled. IGTs are transactions that occur between trading partners within the government. Trading partners are the buyer and seller and are categorized by six levels. Level 1 trading partners are Department reporting entities and other federal agencies such as the DoD to General Services Administration (GSA) or the DoD to the Department of Commerce. Level 2 trading partners are between DoD reporting entities such as Army to Navy or other defense agencies to Air Force. Level 3 trading partners are organizations within a department reporting entity. Levels 4 through 6 are subdivisions of level 3. Level 4 trading partners are between DoD agencies. Level 5 trading partners are between entities of one agency. Level 6 trading partners are within an entity. You will be concerned primarily with levels 1 through 3.

Trading partner transactions could affect line items on the consolidated financial statements. The eliminations process reduces the dollar impact of trading partner transactions, so that the consolidated financial statements show the true condition of the reporting entity. It is important that you know how to identify your agency's trading partners so that eliminating entries can be reconciled.

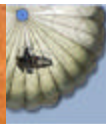


Effects of Intragovernmental Transactions (IGT) on Federal Financial Statements



This chart shows you what happens to intragovernmental transactions when reports are consolidated at the various levels. The legend at the bottom shows the various levels of transaction. The chart shows you the eliminations that are taking place at each of the levels. At the fund level, entries within DoD agencies and services leave the pyramid through the process of elimination as reporting continues to the agency service level. At the agency service level, entries between DoD agencies and services are eliminated as reporting continues to the DoD-wide level. At the DoD-wide level, entries between DoD and other federal agencies are eliminated as reporting progresses to the government-wide level.

Now that you can see how the reader of financial statements will have a clearer picture, let's continue by discussing the effects that accuracy on the financial statement will have on decision-making.



Effect of Accuracy on Statements on Decision-making



Is the error material? Failure to address would results in misstatement.

Is this a systemic problem? Problem goes beyond your organization alone.

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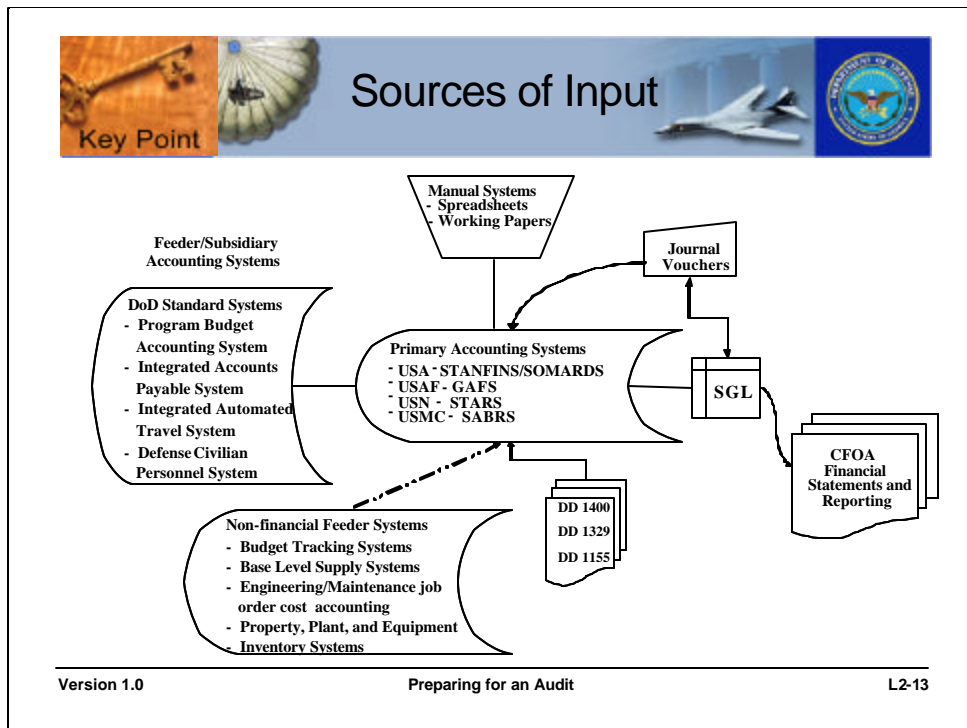
L2-12

Accurate financial statements are the result of sound accounting practices. Remember what we mean by the term material. Materiality is based on the concept that items of little importance, which do not affect the judgment or conduct of a reasonable user, do not require an auditor investigation. In order for an item of concern to be material, it must be significant. Failure to address the item would result in a misstatement that would result in an adverse decision. The auditor will advise the client on materiality thresholds. What is material to the auditor could change each year.

The job of an auditor is to state an express independent opinion that the financial reports of an organization fairly reflect its financial position and operating results. As part of that process, the auditor examines the supporting documents for financial reports and the processes that are used to collect the data. The auditor may take samples of the information and run tests and checks to be certain that the information is correct. In the course of the testing, the auditor may do a statistical sampling. The error may be deemed material or immaterial. If material, inaction may result in a potential risk of fraud and ultimate loss of funds.

Systemic problems are the result of material weaknesses that affect internal control across organizational and program lines and usually affect multiple DoD components. Because of the size of the problem, inaccuracies due to systemic problems must be dealt with at a higher managerial level so the deficiency can be corrected system wide.

Lets talk about the sources of input into an accounting system that will eventually result in financial statements.



Sources of input into financial management systems are generally made through the various service-specific feeder systems. In this diagram there are a number of subsidiary accounting systems and non financial feeder system that are a source of data for the primary accounting system or reporting.

Every day, a document representing a transaction passes over our desks. That document is either a sole source of the input or a supporting document for the input. Supporting document information may have to be compiled into a spreadsheet or other feeder system before it is entered into the accounting system. As seen here, the feeder systems provide information into the consolidated agency financial statements.

There are different types of source documents such as funding documents, work orders, purchase requests, receiving reports, and disbursement forms at various locations in the organization that provide more detail on the transaction. Entity personnel should be aware of their location in support of audits.

Now that we have looked at our sources of input, let's look at our day-to-day operations.



Day-to-Day Operations/ Information



Clear lines of communications include:

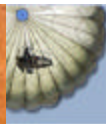
- **a clear understanding of the business process**
- **a clear understanding of the internal controls process**
- **a proper recording of transactions**
- **a list of locations and POCs for original supporting documents.**

Proper daily documentation of recorded transactions equals clean audit trails when auditors visit.

In the course of day-to-day operations, it is important that you build lines of communications and maintain clean audit trails. Clear audit trails are the supporting documents that prove the validity of transaction activity. As part of establishing clear lines of communications, you must understand the internal controls that guide your organization. It is important that you apply this knowledge with your own organization's past experiences with auditing teams and draw from the experiences of other organizations similar to your own, so that you can develop a plan to anticipate future audits. A plan to anticipate future audits results in an organization that is ready to meet the information need of the auditor with minimal assistance.

Recording transactions and working with other POCs to be certain that you have a documented audit trail to substantiate transactions on a daily basis will make the transition into an audit successful. Auditors will appreciate that you understand the documentation that they will need and have a plan in place to present this documentation.

So that you better understand what the auditor may be looking for, let's take a look at the FAM checklist.



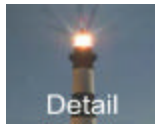
FAM Checklist



**The Government Accountability Office (GAO)/
President's Council on Integrity and Efficiency (PCIE)
Financial Audit Manual (FAM) includes:**

- **Volume 1, Methodology, describes the audit process**
- **Volume 2, Tools, contains the Checklist for Federal Accounting, Reporting, and Disclosures.**

The FAM is comprised of two volumes. Volume 1 describes the audit process, and Volume 2 contains the Checklist for Federal Accounting, Reporting, and Disclosures. In addition, it contains guidance for writing internal controls. Let's take a look at Volume 2 and discuss the Checklist for Federal Accounting, Reporting, and Disclosures.



FAM Checklist (cont.)



FAM Volume 2, Checklist for Federal Accounting, Reporting, and Disclosures contains:

- **questions relating to the financial statements**
- **each question is referenced to a source**
- **questions are grouped by subject area**
- **23 general items questions**
- **355 Balance Sheet questions**

FAM: <http://www.gao.gov/special.pubs/01765G/>

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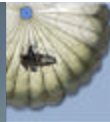
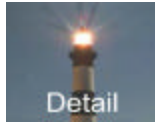
L2-16

The checklist contains questions relating to the financial statements beginning with general items related to the statements, and then to each of the statements, notes, and supplementary information. Each question is referenced to a source. The sources cited are the Statements of Federal Financial Accounting Standards (SFFAS) and OMB Bulletin 01-09, Form and Content of Agency Financial Statements. These questions should serve as the types of questions that you could expect during an interview with the auditor completing the audit.

Questions are grouped by subject area. For example, there are 23 general items questions related to the financial statements and 355 questions related to the Balance Sheet. Since the financial statements are interrelated, some questions concerning line items in one financial statement may also pertain to line items in another statement.

For example, the questions covering loans receivable on the Balance Sheet section may also deal with matters related to interest income and subsidiary expense appearing in the statements of financing and net cost sections. For this reason, questions on related line items appearing in more than one financial statement are covered only in the first financial statement section in which the line item appears. Auditors may ask other related questions concerning receivables such as the status of delinquent accounts and policies used by your organization to recover bad debts.

Let's examine a few sample questions.



FAM Checklist (cont.)



Section III, Balance Sheet, Assets-Accounts Receivable, Question 33:

Is a receivable recognized when a federal entity establishes a claim to cash or other assets against other entities based on legal provisions or when goods or services are provided? (SFFAS 1, par. 41)

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L2-17

This question is extracted from the section of the checklist relating to the Balance Sheet. The affected line on the Balance Sheet that is the focus of this question is Accounts Receivable. Next, notice that the phrasing of the question is a restatement of an accounting rule that has to do with the timing of the recognition of an account receivable. Each question may be answered by Yes, No, or N/A, and space is available at the side of each question for explanation or auditor comments.

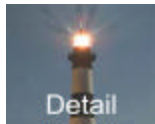
How would the auditor determine how and when an organization recognizes an account receivable?

What specific procedures are in place in the organization to provide instruction on receivables? (DoDFMR, Training, Systems)

Based on original document dates, are specific procedures followed?

How many documents should be examined to verify that the organization (as a whole) is in compliance with this accounting rule?

Let's look at Section V of the FAM checklist.



FAM Checklist (cont.)



Section V, Statement of Changes in Net Position, Budgetary Financing Sources, Question 7:

**Are unexpended appropriations reduced as
appropriations are used? (SFFAS 7, par. 71)**

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L2-18

This section of the checklist relates to the Statement of Changes in Net Position. The affected line on the statement that is the focus of this question is the Unexpended Appropriations line. To understand how the auditor would determine whether unexpended appropriations are reduced as appropriations are used, think about what questions the auditor may be required to ask. Let's examine a few.

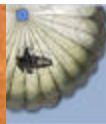
What specific procedures are in place in the organization to adjust the unexpended appropriations totals as the appropriations are used? (DoDFMR, automated systems, controls)

Based on original document dates, are specific procedures followed? (obligation and payment documents)

Are manual adjustments necessary to ensure that appropriations are reduced? If so, when are accounts adjusted?

What must be done to test each system to verify that the organization (as a whole) is in compliance with this accounting rule?

Now let's look at the GAO and its guidance in audits.



GAO



The GAO provides guidance on a variety of subjects:

- **Government Auditing Standards (Yellow Book)**
- **Standards for Internal Control in the Federal Government (Green Book)**
- **Principles of Federal Appropriations Law (Red Book)**
- **Executive Guide: Creating Value Through World-Class Financial Management**
- **GAO/PCIE Financial Audit Manual**
- **Evaluation and Research Methodology (Grey Book)**

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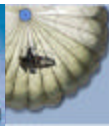
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The GAO provides guidance on a variety of subjects. Of particular interest to the financial community are the references listed here.

They include the Government Auditing Standards, more commonly called the Yellow Book; Standards for Internal Control in the Federal Government (Green Book); Principles of Federal Appropriations Law (Red Book); Executive Guide: Creating Value Through World-Class Financial Management; GAO/PCIE FAM (one that is already familiar to us); and Evaluation and Research Methodology (Grey Book).

Of particular interest in preparing for an audit is the Government Auditing Standards (Yellow Book). Let's discuss this reference.



GAO (cont.)



Government Auditing Standards (Yellow Book):

- **is often referred to as GAGAS**
- **contains standards for audits of the government**
- **pertain to auditors' professional qualifications, audit quality, and audit reports.**

The Yellow Book contains standards for audits of government organizations, programs, activities, and functions.

These standards, often referred to as GAGAS, are followed by auditors and audit organizations when required by law, regulation, agreement, contract, or policy.

They pertain to auditors' professional qualifications, the quality of audit effort, and the characteristics of professional and meaningful audit reports.

Let's examine a few of these standards.



GAO (cont.)



Government Auditing Standards, Chapter 3, General Standards - Independence

“In all matters relating to the audit work, the audit organization and individual auditor, whether government or public, should be free both in fact and appearance from personal, external, and organizational impairments to independence.”

In examining the independence standard, the Yellow Book explains that auditors and audit organizations have a responsibility to maintain independence, so that opinions, conclusions, judgments, and recommendations are impartial and viewed as impartial by knowledgeable third parties.

It goes on to explain that auditors should avoid situations that could lead reasonable third parties with knowledge of the relevant facts and circumstances to conclude that the auditors are not able to maintain independence and, thus, are not capable of exercising objective and impartial judgment on all issues associated with conducting and reporting on the audit.

Let's look at the field work standard.



GAO (cont.)



Government Auditing Standards, Chapter 4, Field Work Standards for Financial Audits

- **AICPA field work standards**
 - **work is adequately planned**
 - **assistants are properly supervised**
 - **understanding of internal controls is obtained**
 - **sufficient evidential matter is obtained**
- **Additional GAGAS standards**

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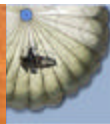
L2-22

Field work is the part of the audit that is conducted at the client's place of business and for this reason standards for field work have been developed. In examining Field Work Standards for Financial Audits, we notice that the AICPA standards are incorporated into the Yellow Book, followed by additional government auditing standards. The three AICPA generally accepted standards of field work are that the work is to be adequately planned, and assistants, if any, are to be properly supervised; a sufficient understanding of internal controls is to be obtained to plan the audit and to determine the nature, timing, and extent of tests to be performed; and sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under audit.

GAGAS prescribes additional standards that go beyond these requirements. These standards relate to:

- auditor communications
- considering the results of previous audits and attestation engagements
- detecting misstatements as a result of contract provisions, grant agreements, or abuse
- violations developing elements of a finding for financial audits
- audit documentation.

Up to this point, we have looked at the auditable data. Now let's look at audit methodology by examining three of the four phases of auditing. They are planning, internal control, and testing. Also, communications will be discussed.



Planning



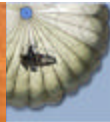
Federal government audit methodology consists of an entrance conference which includes:

- **purpose, scope, and timing of audit information required by auditors, as well as a determination of key members of the staff**
- **physical facilities and equipment needed to complete audit**
- **unit point of contact assigned**
- **auditor contact minimizes disruptions**

The planning phase of auditing allows the senior members of the audit team to determine what evidential matter is needed to achieve the objectives of the audit. Upon notification of audit, you will schedule an entrance conference with the audit team. The purpose of the entrance conference is to:

- introduce the audit team
- describe the purpose, scope, objectives, timing of the audit, and information required by the auditors
- identify agency personnel who need to interact with the auditors
- arrange the physical facilities and equipment needed to facilitate the audit, gain information from key members of the staff regarding their operation, and discuss any audit concerns, key issues, or areas of emphasis.

A unit point of contact should be assigned to coordinate on requirements and preparation for the entrance conference and subsequent audit. Auditor contact is scheduled to minimize disruption of departmental activities. Minutes of the meeting should be taken and made available to the auditors and appropriate agency personnel.



Planning



Additionally, federal government audit methodology consists of:

- **audit work to be done while planning audit activities**
 - **analysis and review of account balance changes**
 - **determine materiality thresholds**
- **tools used as part of the audit methodology**
 - **Prepared by Client (PBC) list**
 - **Process Analysis Documents (PADs).**

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Additional audit work that may be done while planning audit activities are:

- analysis and review of account balance changes to identify the direction of the audit
- determination of what materiality thresholds will be set in the audit testing.

Tools used as part of the audit methodology are:

- the Prepared by Client (PBC) list, which provides information requirements needed to complete the audit and appropriate due dates on when items are needed by the auditors
- the PAD, which is used by auditors to identify system used by the client and where the auditor needs to probe to obtain the underlying accounting data to substantiate individual line items of a financial statements.

The timeline for an audit depends on the depth of the review to be performed by the auditors.



Planning (cont.)



Snapshot of Sample PBC List

Item	Requested Document	Contact and Phone Number	Date Requested	Date Needed	Date Received
	General				
1.	Current version of accounting policies and procedures manual with policies and procedures for Cash and Fund Balance with Treasury, Accounts Receivable, Inventory, Property and Equipment, Advances, Accounts Payable, Accrued Liabilities, and Net Position				
2.	Trial Balance (electronic)				
3.	Access to General Ledger detail				
4.	Crosswalk of accounts to Financial Statement line items				
5.	Statement of intra-departmental elimination entries for FYXXXX				
6.	Management's Discussion and Analysis/Overview				
7.	Draft Financial Statements (electronic)				
8.	Draft Footnotes to F/S (electronic)				
9.	FYXX year-end SF-132s				
10.	Detail Schedule of Undelivered Orders (electronic)				
11.	Post-closing trial balances (electronic)				
12.	Complete Chart of Accounts (if other than SGL)				
13.	Schedule of summarized FACTS data				
14.	Organizational chart(s) of all agency departments indicating key personnel and their responsibilities				
15.	Minutes of the audit committee for the period under audit.				
16.	Annual Performance and Strategic Plans				
17.	Any corrective action plans related to prior year DOD IG, GAO, Defense Contract Audit Agency, internal audit, or external audit report, if any				

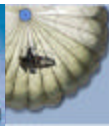
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At the time of the entrance conference, you may receive a PBC list. The PBC list provides a checklist of requested documents broken down as general, compliance with laws and regulations, Fund Balance with Treasury, accounts receivables and revenues, inventories, property and equipment managers, procurement and non-payroll expenses, payroll expenses, net position, and information technology. The PBC list serves as a resource for the audit team to determine who they can obtain information from. It also provides a timeline and control sheet on the receipt of the information. Additionally, as part of the entrance conference, the audit team may entertain suggestions from your management on areas to include in the audit.

Let's talk about PADs.



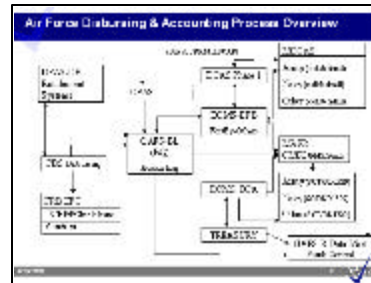
Planning (cont.)



PADs contain five sections:

- Definition
- Process Operation
- Computer Information Systems
- Process-level Risks & Controls
- Acronyms.

Computer Information Systems Example



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The purpose of PADs is to identify the processes and controls used by your organization. It documents how each key process operates and analyzes specific risks and internal controls that are a matter of policy and procedure to safeguard against risk. A typical PAD consists of a scope and limitation narrative, and five additional sections including:

- Definition
- Process Operation
- Computer Information Systems
- Process-level Risks and Controls
- Acronyms.

The scope and limitation narrative describes the parameters of the analysis. Section I, Definition, defines key words and the general processes. Section II, Process Operation, is a more detailed documentation of the individual processes. Section III, Computer Information Systems, gives a description of systems that are used in the process being analyzed and contains flowcharts of operational concepts, functionality, system architecture, system inputs, and outputs. This slide shows an example. Section IV, Process-level Risks & Controls, documents identified risks, the potential effect on financial statements, and controls that are in place to monitor and minimize the risks. Section V, Acronyms, includes all acronyms used in the analysis.

PADs are important to you when preparing for an audit, as they provide the auditor with a complete analysis of a process. Auditors readily review the process and determine areas that require testing. PADs show auditors that you understand the processes in your domain, understand their strengths and weaknesses, and have a plan to minimize risk.

Let's move on to the Internal Control Phase.



Internal Controls



Types of internal controls include:

- **financial reporting**
- **compliance**
- **operations.**

Your management has the responsibility of establishing and maintaining internal controls to provide reasonable assurances that your organization achieves its objectives. During the Internal Control Phase, auditors examine the internal controls of your organization to determine if they are effective .

As part of the examination, the auditor assesses risk control and determines the nature, timing, and extent of the tests. The types of controls that an auditor tests are financial reporting, compliance, and operations controls.

Let's talk about each of these types of internal controls.



Internal Controls (cont.)



Financial reporting internal controls:

- **ensure that transactions are properly recorded, processed, and summarized**
- **safeguard assets against loss from unauthorized acquisition, use, or disposition.**

An example from the FAM checklist, Reporting 1003, Section I, presents the following items for auditor's review:

- **(11a) Evaluate misstatements, including considering whether any misstatements are indicative of fraud.**
- **(11b) Bring all misstatements to the attention of entity management.**

The purpose of financial reporting internal controls is to ensure that transactions are properly recorded, processed, and summarized. Auditors look to see that generally accepted accounting principles are applied to transactions. These recordings are the basis of the information that is contained in financial statements. Financial reporting internal controls safeguard assets against loss from unauthorized acquisition, use, or disposition. An example of internal controls is the requirement for separation of duties.

These items are directly related to financial reporting controls addressed by the FAM checklist.

Now let's look at compliance internal controls.



Internal Controls (cont.)



Compliance internal controls ensure compliance with policies and procedures for managing and controlling appropriated funds.

As an example, the FAM checklist, Reporting 1003, Section I, presents the following items for auditor's review:

- **(5d) identify relevant budget restriction**
- **(5k) access the FMFIA process.**

Auditors reviewing compliance controls look to the laws such as the CFOA and the FFMIA with respect to budget authority, as well as other applicable laws and regulations that have a material effect on financial statements. Budget compliance controls are management's policies and procedures for managing and controlling the use of appropriated funds received through budget authority. Budget compliance controls that govern budget authority are part of the internal controls covered in OMB audit guidance.

As an example, the FAM checklist, Reporting 1003, Section I, presents the following items for auditors review:

- (5d) Identify relevant budget restriction.
- (5k) Access the FMFIA process.

These items are directly related to compliance issues addressed by the FAM checklist.

Let's look at operations internal controls.



Internal Controls (cont.)



Operations internal controls strive to maintain the effectiveness and efficiency of policies and procedures in place to carry out the organizational mission.

Internal control reviews include ensuring that data cannot be inappropriately manipulated.

An example from the FAM checklist, Reporting 1003, Section I, presents the following items for auditor's review:

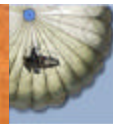
- **(5l) Consider operations controls to be tested**
- **(5m) Understand performance measures controls.**

Organizations need to have published policies and procedures, local guidance, and standard operating procedures that serve as a framework for management to carry out organizational objectives, such as planning, productivity, programming, quality control, economy, efficiency, and effectiveness. The auditors' review ensures that these controls provide reasonable certainty that the entity achieves its mission, and maintains quality standards in a effective and efficient manner.

Systems administration and access and separation of duties controls are not only in the accounting operations but also in system security. Internal control review also includes observation of the processes.

These items are directly related to operations controls issues addressed by the FAM checklist.

The next topic is testing.



Testing



Testing is performed on a sample of the population. How we take the sample is dependent on what is being tested.

Six methods of sampling are:

- **Random sampling for percentages of occurrences**
- **Discovery sampling for exceptions**
- **Variable sampling for numerical measurements**
- **Judgment sampling for limited purposes**
- **Stop or go sampling for conclusions of attribute sample**
- **Stratified attribute sampling for dividing population into classes or strata**

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When testing, it may not be possible to look at the total volume of data available on the basis of time and expense. The total volume of data is called the population, or universe, and it is made up of individual units. It is possible to draw an accurate conclusion by studying a small portion of the individual unit that is part of the population. The portion of the individual unit of data that we have drawn from the large volume of data is called a sample. The goal of an auditor is to make an inference about the entire population based on a sample. This is referred to as inferential statistics.

Methods of sampling are explained below.

- Random attribute sampling is a selection of data to represent the population through a random selection of items, without considering the transaction dollar amount or other special characteristics. It uses percentages of occurrences.
- Discovery sampling is a form of attribute sampling that is designed to locate at least one exception if the rate of deviation in the population is at or above a specified rate.
- Variable sampling is the sampling of numerical quantities. It uses numerical measurements such as mean, median, mode and standard deviation.
- Judgment sampling applies to situations in which judgment is used in determining sample sizes or methods of selection in the place of statistical samples. To employ good judgment sampling, the user must understand the basic principles of statistical sampling so that in situations where statistical sampling is more appropriate it is employed instead. It is important, however, to remember that you cannot make an inference to the population as a whole using judgment sampling.
- Stop or go sampling is an extension of attributes sampling. It is used to reach a conclusion about the upper precision limit of an attribute sample and may allow objective to be attained with a smaller sample size than possible using classical attributes model.

A common variation on sampling methodology is stratified attribute sampling. It is possible to divide a population into classes or strata that are more homogeneous than the population as a whole. Estimates are made from stratified sample with greater precision than if the population was treated as an undifferentiated whole, as would be the case with random sampling. A basic problem with stratified attribute sampling is that it requires that you have considerable knowledge of the population to delineate the strata.

Sample size is determined after a consideration of the auditor's comfort level in the quality of the internal controls. If the comfort level is good then a smaller sample size will be adequate. If the auditor has discomfort in an internal control then a larger sample size is necessary. Auditors use computer software to determine the sample size based on their comfort level. Once the auditor has a sample, it can be determined if a deviation is significant enough to be material.

Let's look at three types of testing and relate them to attribute and variable sampling.



Testing (cont.)



Which test we use is dependent on what we are testing for - internal controls, compliance with laws, or financial statements.

Types of testing include:

- **sampling control tests – test to see if entity has achieved the objective of the internal control**
- **compliance tests – test to see if entity is in compliance with laws and regulations**
- **substantive tests – performed to obtain evidence of reasonable assurance.**

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There are three types of testing that can be performed: sampling control, compliance, and substantive tests. Sampling control tests are performed on internal controls to see if the entity has achieved the objective of that internal control. Compliance tests are performed to see if the entity is in compliance with laws and regulations. Substantive testing is performed to obtain evidence that provides reasonable assurance. Auditors plan a sampling control test by determining the objectives of the test (including what constitutes a deviation), the population (including sampling unit and frame), the method of selecting the sample, and the sample design and resulting sample size. The plan that the auditor chooses must be documented in the work papers for the audit. Sampling control tests use the random attribute sampling, as the data is to be non-numeric.

Compliance tests are based on three types of provisions: transaction-based provisions, quantitative provisions, and procedural provisions. A transaction-based provision tests compliance by looking at individual transactions. A quantitative provision tests compliance by looking at information that falls within a definitive range. The auditor may specify a minimum, maximum, or targeted amounts (restrictions) to accumulate or summarize information. Using a procedural provision, auditors test by obtaining sufficient evidence to make a judgment on whether the entity performed the procedure and complied with the provisions. Compliance tests use random attribute sampling, as they test for compliance to laws and are non-numeric.

While performing a substantive test, the auditor looks at individual line items on a financial statement to determine if there may be a material misstatement of the information. Substantive tests use variable sampling, as the testing is applied to the numbers on a financial statement. Now that you understand about sampling, you must now determine if the sample is a reflection of what is expected, or if it falls outside the range of what is acceptable. The process that you use to determine this acceptability is statistics.



Testing (cont.)



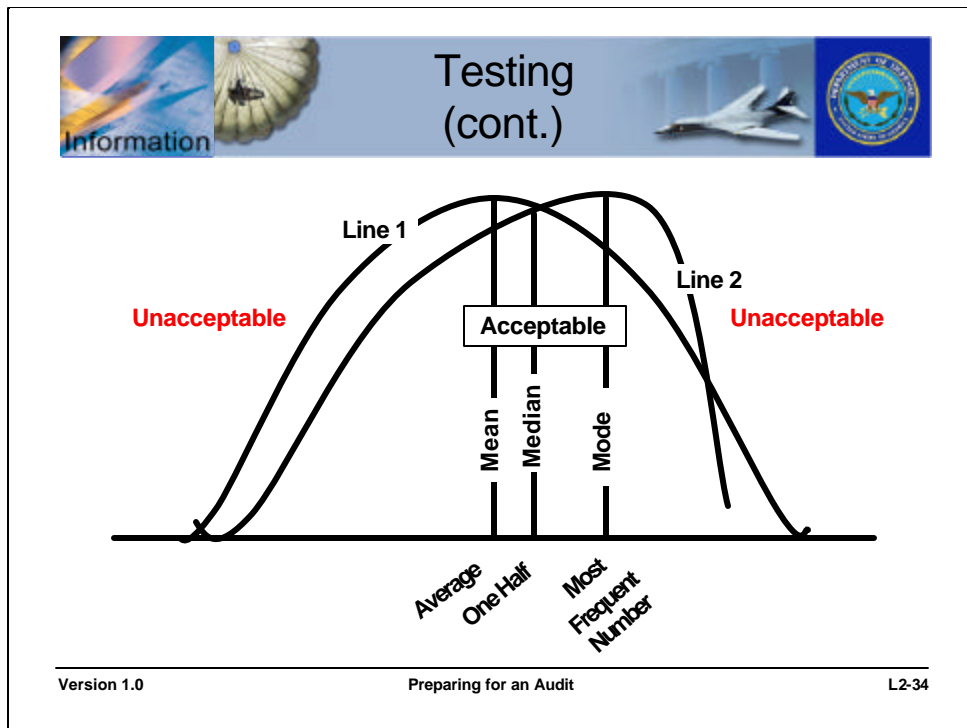
Statistics are numbers that carry information pertaining directly to samples and indirectly to population.

If sample is within range then it is immaterial and acceptable.

If sample is outside the range it is material and a cause for concern.

Statistics are numbers that carry information pertaining directly to samples and indirectly to population. This really speaks to the heart of what you have seen with respect to sampling. The auditors want to determine if the sample of data statistically falls within an acceptable range that has been set. In other words, if it is within the range then it is immaterial and acceptable; but if it is outside the range it may be material and a cause for concern. Whether acceptable or unacceptable, the statistical measure that the auditors use speaks directly to the sample being tested, and indirectly to the population as the sample is assumed to be a characteristic of the population.

Now let's look at some of the statistical measures.



You statistically measure central tendencies, variabilities, and relationships. Central tendencies are the mean, the median, and the mode.

The mean is the average you learned about in grade school. On the chart, the mean divides the two equal sides of the bell shaped curve perfectly in half.

In contrast, the mode is the point where the greatest number of students scored. As an example, let's consider that from our statistical calculation we determine that from a classroom of 20 students, 15 scored 85%, two scored 100%, and three scored 75%. The mode would be 85%, as this is the grade that most students scored.

The median tells us the point at which a distribution is divided in half. Line 1 on the chart shows a bell-shaped curve or a perfect distribution (both sides of the curve when divided in half are the same). In this case, the median is the same as the mean. Line 2 on the chart shows a curve that is not perfect. As the median is the central point between the lower and upper half of the distribution and the distribution is not perfect, the median is not in the center.

Why is this important to you? As you saw before, you need to know that when something falls outside an acceptable range, the statistics show us where we are. We can further use statistics to define what's acceptable. If outside that range, you may want to look for the reason why and solutions.

Let's take a look at an example of a checklist used by auditors to audit Defense Military Pay Office (DMPO) travel pay.



Testing (cont.)



EXAMPLE PROCESS CONTROLS FOR DMPO TRAVEL PAY

- **Are statistical sampling methods used to review vouchers under \$2,500? Are all reviews documented and signed? (Ref DFAS-IN 37-1 Appendix N)**
- **Is the sample number of vouchers reviewed justified by the error percentage rate? (Ref DFAS-IN 37-1 Appendix N)**

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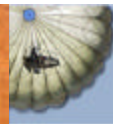
Preparing for an Audit

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These are examples of questions from a Process Controls checklist for DMPO travel pay. The DMPO performs statistical sampling on their processes throughout the year. Based on the results of their sampling the auditor considers his comfort level on the DMPO sampling methods and the extent of his sampling.

Let's look at the first question; are statistical sampling methods used to review vouchers under \$2,500? This establishes a threshold for vouchers requiring statistical sampling. The question that follows; is the sample number of vouchers reviewed justified by the error percentage rate? This asks if the sample was large enough in consideration of the auditors expected error rate. The error rate is what the DMPO may consider an acceptable rate of errors. The sample may be taken to determine if errors are prevalent and if they fall outside of the expected range of error.

Now let's look at communications. How can you improve your organization so that when the auditors appear, you can keep performing at your job and satisfy their thirst for information?



Communications



Best practices to improve auditor/client relationships include the following.

- **Needed equipment is available.**
- **Quality review teams are in place to look at samples of auditable information.**
- **Proper supporting documentation exists (JV and corrections to JV).**
- **POC liaisons are established (continuity is important).**
- **Use PBC.**
 - **Have most knowledgeable players involved.**
 - **Documentation folders are organized.**

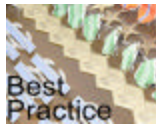
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Preparing for an Audit

L2-36

Communication between you and the auditor is an ongoing process, and the proper management of the audit will only improve the relationship that you have with your auditors. Let's look at some of the best practices with respect to communication between you and the auditor.

- You need to be certain that you have the proper equipment available for the auditors. They need to have access to a fax machine and computers.
- Have a quality review team look at samples of the auditable information as an auditor would to determine if there is something that needs to be addressed. It is better to know the problem and have recently taken action to prevent reoccurrence than to be unaware of the problem and act surprised.
- One of the first items that auditors look at are journal vouchers (JVs) and corrections to JVs, so let's use this process to make a point. Analyze the process that you currently use when you prepare and record JVs. Don't overstate or understate the process. Ask yourself, why are they done? Is there supporting documentation that is valid, justified, and tracks the process to provide a clean audit trail? Will your answers to these questions be acceptable to auditors? Have a clear understanding between yourself and the auditors of the proper supporting documents for items being examined. You must have this knowledge the year prior to the audit so you're collecting the information throughout the year. If you know what the auditors are looking for, you can set up folders ahead of time and properly collect all items needed. This reduces the time for the preparation of the audit and frees you to continue to handle work tasks while the audit is in progress.
- Assign a POC liaison to keep continuity and awareness throughout the process. Expectations between you and the auditors can be established at the time of the entrance interview in conjunction with a PBC list to comply with the time sensitivity of the distribution of information to the auditors, and those they need to communicate with.
- The PBC list includes items that the auditor needs, who will provide them, and a timeline that the auditor can expect the information. You know who the players are in your organization, so have a PBC list prepared before the audit. Manage who talks to auditors by getting the people who know the areas to be audited, to communicate with the auditors. Personnel assigned to this task should have auditing and accounting background, be strong-willed, and know how to communicate. They need to know more about the business than the auditors so they can lead and guide them. This will also aid in the audit as the auditor will be less likely to misinterpret findings. Delineate roles and responsibilities of the auditor and you. Within your organization, there may be many different levels, for example, the roles of management and field personnel. The role of management and field personnel are different during the audit process. Auditors will need room to work. It is important that room is allocated so that the auditor can do their job.



Communications (cont.)



Best practices to improve auditor/client relationships (cont.):

- **Management communication plan and outline is established.**
 - **Shows commitment and can be simple**
- **Positive attitude**
 - **Auditors findings – management plan of action**
- **Feeder systems are identified.**
 - **Manual and automated**
- **Website is developed.**

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Preparing for an Audit

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- Have a communication plan and outline developed by top management to demonstrate that they are involved in the resolution of auditor findings and that they are committed to the process. Communication plans are as simple as two people making it a matter of procedure that they talk every Monday to discuss a specific operation.

- Management's positive attitude and commitment to the process will be infectious throughout the organization. Management must act on the auditor findings with a plan of action. This plan is a living document and all levels must be mindful of the status of corrective actions throughout the year. Everyone must be willing to accept change, develop a new mindset, and take ownership of the audit findings, if an unqualified audit is going to be achieved.

- Identify what feeder systems you use and how to reconcile them with the accounting system. These systems are not only automated, but manual, run by people. Communicate with those people on a daily basis to discuss what can be done to improve the process. We talked about PADs and their importance in analyzing the processes, automated and manual, that you use to meet your objectives. Are there checks and balances in place that help you reconcile the data? It's a good idea to develop a reconciliation checklist as a tool.

- Develop a website and a monthly newsletter to communicate ideas that are helpful to overcome obstacles. Share the data throughout your organization and others to improve audit preparation.



Lesson Summary



Data is only as good as the feeder system that collects the specific information.

The proprietary and budgetary information that is reported by the general ledger system must be audited to be certain that processes and internal controls are being adhered to and are working.

There is no substitute for quality communications.

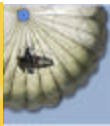
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In this lesson, you learned that feeder systems provide specific data to the general ledger. These systems, both manual and automated, must be audited to be certain that there are no material misstatements of information to the general ledger. The financial statements are the product of the general ledger. They report proprietary and budgetary information. Auditors test the soundness of the line items of these statements and the internal controls of an entity using statistical testing. Both internal and external communications play a role in the continued financial strength and viability of all entities in the DoD.

The following slide lists references available for additional information.



References



TFM: <http://fms.treas.gov/tfm>

DoDFMR: <http://www.dod.mil/comptroller/fmr/>

GAO: <http://www.gao.gov>

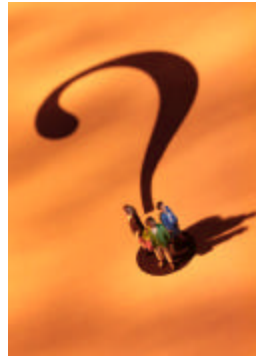
FASAB GAAP: <http://www.fasab.gov/accepted.html>

FASAB Standards and Concepts:
<http://www.financenet.gov/fasab.htm>

Office of Federal Financial Management:
<http://www.whitehouse.gov/omb/financial/>



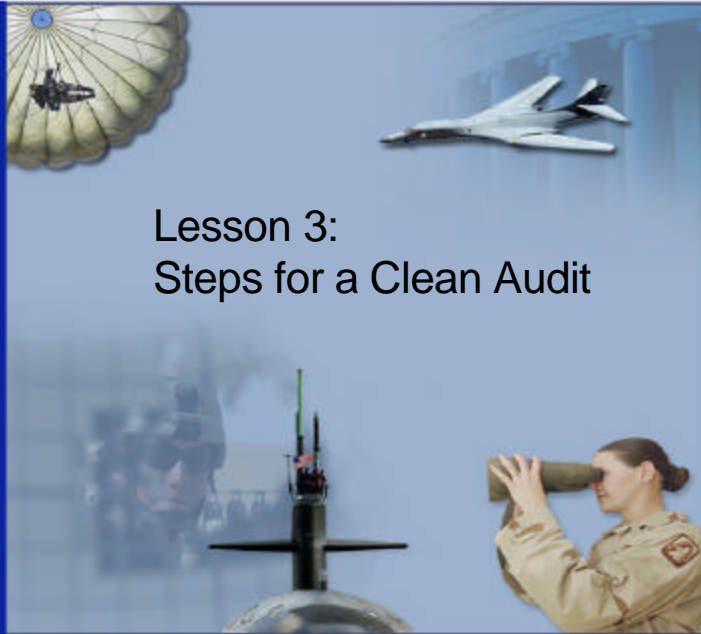
Questions



Preparing for an Audit



Lesson 3: Steps for a Clean Audit



The DoD annually receives a disclaimer of opinion on its agency-wide financial statements because it does not substantially conform to Generally Accepted Accounting Principles and its systems are unable to adequately support material amounts on the statements. Receiving an unqualified audit opinion provides assurance that every line on the financial statements has reliable data that is traceable to source records and was posted in accordance with laws and regulations.

In Lesson 3, we explore the steps to prepare for a clean audit.



Lesson Objective



Upon successful completion of this lesson, you will be able to explain the steps to prepare for an audit.

Section 1008 of the National Defense Authorization Act for Fiscal Year 2002 required that the Under Secretary of Defense (Comptroller) (USD(C)) assess the reliability of the DoD financial statements, including the financial statements of each component. Entities were directed to prepare preliminary representation letters regarding the reliability of their financial statements.

For those statements represented to be unreliable, the USD(C) redirected resources expended on financial statement preparation to efforts toward improving the entity's ability to report reliable financial information. The Financial Improvement Initiative Business Rules are designed to prepare each reporting entity for an audit. Once a reporting entity represents that its financial statements are reliable, Section 1008 no longer applies to that entity, and the DoDIG performs a full financial statement audit of the entity in preparation for the DoD-wide independent audit.

Upon successful completion of this lesson, you will be able to explain the steps to prepare for an audit. Now let's examine the topics covered in this lesson.



Lesson Topics



This lesson contains the following topics:

- **Roles and Responsibilities**
- **Financial Improvement Initiative**
- **Discovery and Correction**
- **Validation**
- **Assertion**
- **Assessment**
- **Audit**
- **Reporting**

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Preparing for an Audit

L3-3

In this lesson we will discuss the roles and responsibilities of the auditor, audit liaison, managers, DFAS, and the 21 DoD reporting entities. We will also discuss the five-phase process used by the DoD leadership to move it's entities' financial statements from a position of unreliability to reliability and, ultimately, to an unqualified audit opinion.

According to the USD(C) Memorandum dated June 23, 2004, Subject: Financial Improvement Initiative Business Rules, the process for preparing for an unqualified audit opinion is described within the Discovery and Correction, Validation, Assertion, Assessment, and Audit Phases.

We will finish with a discussion of reports that are required in preparation for the audit.

Let's begin with the Roles and Responsibilities topic.



Key Point



Roles and Responsibilities





Auditor



Audit Liaison



DFAS



Managers



DoD Reporting Entities



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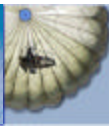
L3-4

We will discuss the roles and responsibilities of the auditor, the audit liaison team members, managers, DoD reporting entities, and DFAS in relation to what is required at each phase of the audit preparation.

In addition to individual roles and responsibilities, there are some roles and responsibilities that apply to everyone. We must ensure that there is adequate evidential documentation, including both system files and hard copy documentation, as necessary. We must also verify procedures and controls, know the numbers reported on our financial information, and be able to explain abnormalities and normal fluctuation.

We must remember the importance of communication with individuals directly involved in the audit process and throughout the organization. Communication is also critical between the organization and the auditor.

Now let's talk about the auditor's roles and responsibilities.



Roles and Responsibilities



Auditor: The DoDIG is the independent auditor of the Department.

- Independent objective unit
- Performs independent reviews of agency programs and operations
- Responsible for financial audits within the Department
- Identifies material weaknesses



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Preparing for an Audit

L3-5

The mission of the Office of the Inspector General is to be an independent and objective unit within the DoD that conducts and supervises audits and investigations relating to the programs and operations of the Department. The Inspector General Act provides for independent reviews of agency programs and operations.

The Inspector General is charged with the responsibility for the audits of the financial statements. As the Department's financial operations are updated and its financial statements become ready for audit, it will be the DoDIG who will either perform the audits or contract with Certified Public Accounting (CPA) firms to perform audits under the supervision of the Inspector General's staff.

The DoDIG is a key partner in the Financial Improvement Initiative and provides its expertise in a variety of ways. For example, the DoDIG identified 11 material weaknesses that were reported in the Department's FY 2004 Performance and Accountability Report. In this way, the DoDIG assists the Department in determining what needs to be updated. Additionally, the DoDIG staff participates, as non-voting members, on the audit committees established by each of the components that prepare audited financial statements. The DoDIG holds advisory membership on the Executive Steering Committee (ESC), the Review and Prioritization Subcommittee (RPS), and the Funding Subcommittee, which make up the governing structure for the Financial Improvement Initiative.

Let's discuss a few more of the duties of the DoDIG auditors.



Roles and Responsibilities (cont.)

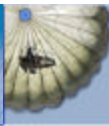


Auditors Duties:

- **Obtain an understanding of internal controls.**
- **Provide the PBC list.**
- **Examine evidence.**
- **Assess or audit.**
- **Communicate progress and issues.**
- **Express an opinion.**

When an entity or area is selected for audit, the auditors obtain an understanding of the agency's internal controls by reviewing the reporting entity's assertion package. Auditors then provide a list of items that will be required for the audit in advance of the start of fieldwork. This list is often referred to as the PBC list. They examine, on a test basis, evidence supporting the amounts and disclosures in the financial statements. If the results of the assessment show that an area does not appear to be ready for audit, the auditors identify specific deficiencies and provide recommendations. If the results show that an entity is ready for audit, the auditors apply audit procedures. DoDIG auditors may conduct the audit, or they may contract with a CPA firm to do the audit in a professional and effective manner. They communicate progress and issues encountered promptly, and finally express an opinion.

We've discussed the role of the auditors, now let's look at the role of the audit liaison.



Roles and Responsibilities (cont.)



Audit Liaison:

- **Entity representatives with knowledge of information or evidential matter needed by auditors**
- **Managers, technicians, and staff**
- **Ability to explain departures from normal procedures**



A well-prepared organization is represented by a team of individuals that are responsible for the overall presentation of information to the auditors and works as the liaison with auditors. Team members should be chosen for their knowledge of entity operations, procedures, and financial position. They must be able to respond to questions concerning financial data and entity operations.

The team may be composed of entity managers, technicians, and supporting personnel, in-house or contracted. Audits are lengthy and ongoing processes. Representatives must be available to work with auditors for extended periods. Ensuring that staff is available while still accomplishing the normal operations is a challenge that management must meet. Staff assigned to the financial statements should collectively possess adequate knowledge of the organization, functions, systems, and mission.

Selected members should know what normal balances, transactions, and procedures are and be able to explain any abnormalities. Any departures from normal procedures must be accompanied by evidence of proper justification and approval. Individuals within an organization should understand their importance to this process and how each can contribute to the success (or failure) of the organization.

Let's examine the duties of the audit liaison team members.



Roles and Responsibilities (cont.)



Entity-Auditor Liaison POC Duties

- **Audit record-keeping**
 - open requests
 - documents supplied
 - corrections made
 - deficiencies noted, awaiting correction
- **Explanation of internal controls**
 - financial reporting controls
 - compliance controls
 - operations controls
 - system controls
- **Information gathering**
 - data queries and document searches
 - standard queries prepared in advance
- **Audit Committee**
 - member selection

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L3-8

The audited entity should assign a point of contact (POC) to work with the auditors. Among the POC's duties are the audit record keeping, information gathering, explanation of internal control activities and procedures, and other liaison between the audit staff and entity personnel.

Audit record keeping includes maintaining a record of requests for information from the auditor, and the appropriate records of the fulfillment of these requests. Requests come in many forms, but the most common is the PBC list. This list is a record of requested information and documentation, date needed, date supplied, and the entity POC for additional detail. Once the audit begins, information must be gathered to provide requested record for review by the auditor. Gathering information may include data queries and document searches.

You may establish processes prior to the audit to facilitate speedy data access. Standard queries run on sample data may ensure that processes and queries provide the required information, while tests may ensure that procedural problems that allow for errors in documentation are discovered prior to the audit. Proper sample information must be able to be traced from the transaction level to the financial statements.

Explaining internal controls begins with the identification of controls and systems. These include financial reporting controls that lead to the financial statements, compliance controls, and certain operations controls. Information system controls include general controls, application controls, and user controls.

The audited entity must set the tone for the audit at the first contact with the auditor. The establishment of an audit committee and the member selection are key to ensuring that the auditor understands that the entity is serious about obtaining an unqualified audit opinion and has devoted the resources to that endeavor.



Roles and Responsibilities (cont.)

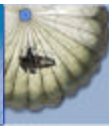


Liaison Activities:

- **Communicate the scope**
- **Identify required information**
- **Identify required resources**
 - telephones
 - fax machines
 - copiers
 - computers
 - office space
- **Organize meetings**

Liaison activities include communicating the scope of the audit and information and resources required, to include equipment such as telephones, fax machines, computers, and office space. Liaison activities also include the organization of meetings with the auditor.

Now let's consider the role of the individual managers.



Roles and Responsibilities (cont.)



Manager's Role:

- **OMB Circular A-123 outlines managers responsibilities**
- **Take systematic and proactive measures**
- **Report annually on controls**
- **Audits are assessments of how well an entity controls its resources**



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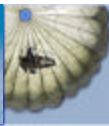
L3-10

According to OMB Circular A-123, Management Accountability and Control, managers are responsible for the quality and timeliness of program performance, increasing productivity, controlling costs and mitigating adverse aspects of agency operations, and assuring that programs are managed with integrity and in compliance with applicable law.

Managers must take systematic and proactive measures to develop and implement appropriate, cost-effective management controls, assess the adequacy of management controls in their programs and operations, identify needed improvements, take corresponding corrective action, and report annually on those controls.

Audits are assessments of how well an entity controls its resources. Agency managers are required to follow up on audit recommendations and correct problems resulting from inadequate, excessive, or poorly designed controls, and to build appropriate controls into new programs. In designing appropriate controls, managers must communicate their DoD and systems issues to their Office of the Under Secretary of Defense (Comptroller) (OUSD(C)) POC.

Let's discuss these duties in more detail.



Roles and Responsibilities (cont.)



Manager's Role (cont.):

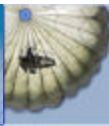
- **Financial statements**
- **Assuring reliability of information in reports**
- **Testing, reconciling, and analyzing financial data**
- **Management representation letter**
- **Audit engagement letter**

The financial statements and accompanying footnotes are also the responsibility of management. This reporting package contains management discussion and analysis of the financial information presented. The management discussion and analysis is an executive summary of the results of operations, accomplishments, use of resources, and any unusual circumstances.

An audit tests the reliability of the information provided by management in the form of financial statements, reports on management controls, or other assurances or representations. One of the procedures used by management in the accomplishment of their duties involves testing, reconciling, and analyzing specific financial data to validate the information presented for audit.

Management then prepares a representation letter that attests to management's responsibility for the information provided for audit. An engagement letter is prepared to form an agreement with the auditor and the audit is conducted on the areas represented.

Let's look at a few of the procedures that are used by management in validating this information.



Roles and Responsibilities (cont.)



Procedures used by managers:

- **Calculate variances.**
- **Compare current to prior periods.**
- **Compare related data.**
- **Analyze account balances and age.**
- **Any unusual balances or significant entries must be explained.**

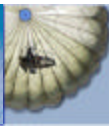
Financial data is analyzed in a variety of ways; one of the more common methods of analysis is to calculate absolute variance of line items.

Managers must understand the reasons for variances and be able to present this information to users of the financial data. The inability to explain variances may lead auditors to think about control weaknesses, fraud, and inherent risks. Some of these steps are also completed as part of the audit process.

Reconciliation of financial statements involves comparing current period data to prior period data, and related balances from one financial statement to another in the same period such as the Statement of Budgetary Resources to the Statement of Net Cost. Any differences between expected balances and actual data must be explained during the audit. Managers should analyze general ledger accounts and balances. Any unusual balances or significant entries must be also explained. Explanations must be made in a meaningful, non-technical manner.

This analysis gives you a better understanding of the financial position of your entity and how significant management decisions affect that financial position.

Now let's look at documenting the flow of data.



Roles and Responsibilities (cont.)



Procedures used by Managers (cont.):

- **Document data flow.**
- **Ensure availability, completeness, accuracy, and validity of supporting documentation.**
- **Identify and test controls and systems.**
- **Staff adequately.**

Documenting the flow of data is a process by which transaction data is traced from initiation, through the financial and non-financial feeder systems, to the eventual reported financial information. Some data that supports a financial transaction is not strictly financial data such as time and attendance records, inventories, transportation bills of lading, or property deeds. Documenting the flow of data is a critical step in preparing for an auditable universe. An auditable universe exists when supporting documentation is available, complete, accurate, and valid for all audited transactions.

Once the flow of data is documented, testing of controls and systems for the reporting of that data begins. Tests of controls and systems are designed to ensure that transactions are properly authorized, that resources are protected, and that systems support appropriate controls.

Management must ensure that sufficient knowledgeable staff is available, not only to support the audit, but to support ongoing financial management efforts. Financial management occurs throughout the year, not just at year end. Managers must communicate audit requirements to members at all levels of the organization.

Let's now talk about the role of the DoD reporting entities.



Roles and Responsibilities (cont.)



DoD Entities Reporting to OMB

Agency-wide statements are required to cover all accounts and associated activities of each office, bureau, and activity of the Department.

Military departments and defense agencies are working diligently to correct the deficiencies that are keeping them from asserting that they are ready to have their financial statements audited.



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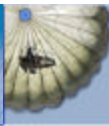
L3-14

The OMB requires the DoD to prepare agency-wide audited financial statements in accordance with the Government Management Reform Act (GMRA) of 1994. The agency-wide statements are required to cover all accounts and associated activities of each office, bureau, and activity of the Department.

Financial improvement plans designed to ensure that the Department achieves an unqualified audit opinion have been prepared by the military departments, defense agencies, and other primary fund-holders.

As the largest fund-holders in the Department, the military departments (Department of Army, Department of the Navy, and Department of the Air Force) are key elements in the Financial Improvement Initiative. Additionally, they hold the greatest share of the assets reported on the Department's agency-wide balance sheet. Most of the process and control changes necessary to the initiative must be implemented within the military departments and the defense agencies. These departments and agencies are working diligently to correct the deficiencies that are keeping them from asserting that they are ready to have their financial statements audited.

Let's continue.



Roles and Responsibilities (cont.)



DoD Entities Reporting to OMB (cont.):

- Army General Funds
- Navy General Fund
- Air Force General Fund
- Military Retirement Fund
- Missile Defense Agency
- Defense Commissary Agency
- Defense Contract Audit Agency
- Defense Finance and Accounting Service
- Defense Information Systems Agency
- Defense Security Service
- Defense Logistics Agency
- Army Working Capital Funds
- Navy Working Capital Fund
- Air Force Working Capital Fund
- Defense Threat Reduction Agency
- Defense Advanced Research Projects Agency
- Nuclear Chemical Biological Defense Program
- Army Corps of Engineers Civil Works Program
- DoD Medicare Eligible Retiree Health Care Fund
- Defense Health Program

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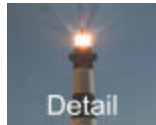
Preparing for an Audit

L3-15

As with the military departments, defense agencies are active partners in the Financial Improvement Initiative. Defense agencies perform a variety of support missions within the Department. Those agencies listed here are required to prepare audited financial statements and are especially important in the updating of the Department's financial operations. Along with the military departments, these agencies make up the greatest portion of the Department's financial activity.

The 21 reporting entities are comprised of the military departments' General and Working Capital Funds and several defense agencies. While included in the DoD agency-wide statements, they are also required to prepare stand-alone audited financial statements. Other defense organizations that are not currently required to publish financial statements that are audited are required to prepare financial improvement plans in preparation for that requirement at a later date.

One agency that is particularly important to the auditing effort is the DFAS. Let's examine the role of this agency.



Roles and Responsibilities (cont.)



DFAS provides finance and accounting services for the DoD. DFAS initiatives are focused on fixing business processes that are within its control, such as:

- **Fund Balance with Treasury**
- **Accounts Receivable and Accounts Payable**
- **DFAS systems**
(DFAS is not responsible for feeder systems not under their control).



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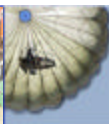
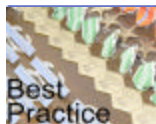
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L3-16

The mission of DFAS is to provide responsive, professional finance and accounting services for the people who defend America. In providing these services, one of DFAS's goals is to fully satisfy customer requirements and aggressively resolve problems to deliver best-value services. In doing this, DFAS must continually review current finance and accounting systems and procedures, and identify improvements that can be made to processes and systems. DFAS initiatives are focused on fixing business processes that are within its control, such as Fund Balance with Treasury, accounts receivable and accounts payable, and DFAS systems. DFAS is not responsible for feeder systems not under their control.

DFAS has already held DoD-wide conferences on DFAS business processes and systems audits with customers, the DoD audit community, and the Government Accountability Office.

Let's look at a few useful practices that you may implement in preparing for an audit of your entity.



Roles and Responsibilities (cont.)



Useful Practices:

- **Plan meetings.**
- **Implement schedules and hold regular progress meetings.**
- **Discuss new standards and policy.**
- **Discuss findings and audit adjustments.**
- **Review interim financial statements.**
- **Review lessons learned.**

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Preparing for an Audit

L3-17

Here are a few practices that you may find useful. Meetings should be planned with a clear agenda that lists topics to be discussed. Any read-ahead material should be distributed well in advance of the meeting to ensure that participants have ample time to plan their own comments. It should start and end on time, but should allow time for discussion.

Schedules should be implemented that build into the reporting entity's financial improvement plans the plans for their suballotees (subordinate organizations). Regular progress meetings should be held to establish communication lines between the reporting entity, their suballotees, and their OUSD(C) POC. Regular communication should discuss new standards and policy to ensure the widest dissemination throughout the entity. Those most affected by changes to standards or policy may require specific training.

In discussions of findings and audit adjustments, entity management should identify action teams to plan and implement solutions. Reviews of interim financial statements may point out trends or unusual activity that can be corrected immediately, or that may require action or explanation at a later date.

Many organizations publish lessons learned from previous inspections, reviews, and audits. Review of these lessons both within and outside your organization may prevent you from making similar errors. They may also point out deficiencies within your organization that had not been identified previously.

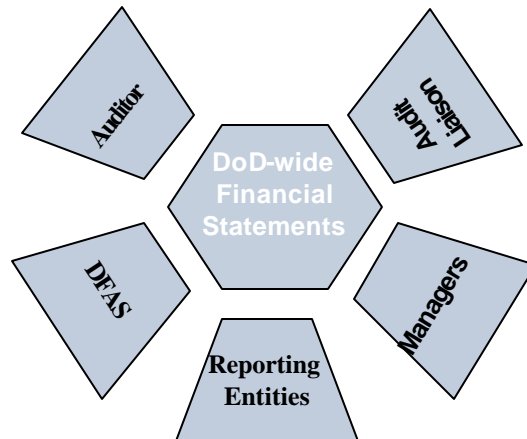
Let's take a moment to recap some of the key roles and responsibilities.



Roles and Responsibilities (cont.)



Recap



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L3-18

So far, you've learned that auditors provide an independent assessment of the general reliability of the financial statements or specific line items.

The audit liaison team is responsible for the overall presentation of information to the auditors.

Managers are responsible for program performance.

DoD reporting entities include the military departments, defense agencies, and other primary fund-holders. Financial improvement plans designed to ensure that the Department achieves an unqualified audit opinion have been prepared by the reporting entities.

DFAS continually reviews current finance and accounting systems and procedures to identify improvements that can be made to processes and systems.

Now that we've discussed the roles and responsibilities, let's discuss the five-phase process used by the DoD leadership to prepare for an unqualified audit opinion.



Financial Improvement Initiative



Major Phases

Discovery and Correction	Validation	Assertion	Assessment	Audit
WHY <ul style="list-style-type: none"> Discover problems Evaluate solutions Plan solutions Correct processes Complete policy Complement BMMP HOW <ul style="list-style-type: none"> Develop improvement plans Establish audit committees Develop systems strategy Prepare business cases for systems changes Prepare and review full set of financial statements each quarter 	WHY <ul style="list-style-type: none"> Enhance credibility of assertions HOW <ul style="list-style-type: none"> At beginning, coordinate and obtain comment from DoDIG and notify RPS Management documents processes, identifies controls & systems, and ensures auditable universe of transactions & supporting documentation is available Management requests validation of financial information Performed by internal review, component's audit agencies, or external audit firm 	WHY <ul style="list-style-type: none"> Communicate to DoDIG and auditors reliability of financial information HOW <ul style="list-style-type: none"> Assertion letter to DoDIG that: <ol style="list-style-type: none"> Responds to DoDIG's instructions Includes checklist Includes results of validation and reports Engagement letter and management representative letter, if used Memo to DoDIG, copy to OUSD (C) RPS ESC approval for assessment/audit 	WHY <ul style="list-style-type: none"> Allows remediation Attests to management assertion Plan audit Reduce risk of unknowns (auditor) Introduction to organization (auditors) HOW <ul style="list-style-type: none"> DoDIG oversight of IPAs DoDIG in-house 	WHY <ul style="list-style-type: none"> Implement CFO Act Implement 1008 Presidents' Management Agenda HOW <ul style="list-style-type: none"> Pass assessment DoDIG oversight of IPAs

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Section 1008 of the National Defense Authorization Act for Fiscal Year 2002 required that the USD(C) assess the reliability of the DoD financial statements. For those statements deemed unreliable, the USD(C) redirected resources expended on financial statement preparation to efforts toward improving the entity's ability to report reliable financial information.



DoD is accomplishing the difficult task of improved financial management through several initiatives including the Financial Improvement Initiative. One of the indicators of success is an unqualified audit opinion on the Department's financial statements. The scope of this improvement initiative encompasses policies, processes, controls, defense business systems, personnel, organizations, performance metrics, and auditor assessments and audits that are directly or indirectly related to DoD Financial Management.

The Financial Improvement Initiative is a five-phase process designed to prepare entities to pass a financial audit and to improve their ability to control and report on their financial activities.

The first phase of this initiative is the Discovery and Correction Phase. Let's begin with this phase.

Discovery and Correction

Discovery and Correction Phase:

Management identifies deficiencies and implements corrective actions.

Why	How
Implement 1008, discover problems, evaluate solutions, correct processes, complete policy, complement BMMP	Develop improvement plans, establish audit committees, develop systems strategy, prepare business cases for systems changes, prepare and review financial statements each quarter

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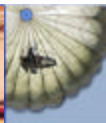
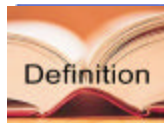
L3-20

The Discovery and Correction Phase is intended to correct deficiencies and plan solutions to produce accurate data.

As managers, you must identify problem areas or deficiencies, then develop solutions to those problems. Problems may be identified from prior assessments or audits, analysis, tests of controls, or internal reviews of operations and procedures. They may include DoD issues and systems, issues affecting your subordinate organizations (your suballotees), or issues that are internal to your operation. Once problems are identified you develop plans for corrective action.

These plans must include responsibility, milestones, and required resources. They should take into account the plans of your subordinate organizations and may depend on the plans of higher organizations or operations. You must monitor progress both within and outside of your organization to ensure that milestones are reached. Resources outside of your organization may be available to you, and solutions found by other organizations may be applicable to problems within your operation. Plans for corrective action may already be initiated on deficiencies found on previous audits and assessments, and new problems may be identified during their correction.

Let's break this phase down into it's two components, discovery and correction.

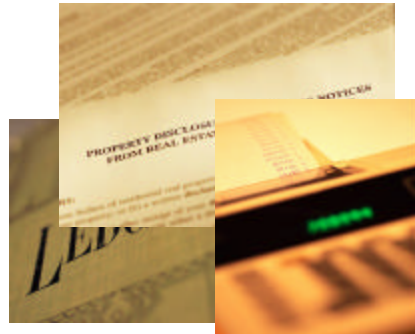


Discovery and Correction (cont.)



Discovery: identify obstacles and prepare corrective action plans in pursuit of an unqualified audit opinion.

- **Prepare the financial improvement plans.**
- **Identify all known deficiencies.**
- **Consider whether systemic problems exist.**



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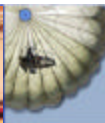
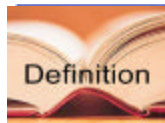
L3-21

The purpose of discovery is to identify obstacles that could prevent the entity from obtaining an unqualified audit opinion and to prepare improvement plans with solutions that have measurable outcomes for overcoming those obstacles.

Agency managers and staff should be encouraged to identify and report deficiencies, as this reflects positively on the agency's commitment to recognizing and addressing management problems. Failing to report a known deficiency would reflect adversely on the agency. Agencies should carefully consider whether systemic problems exist that adversely affect management controls across organizational or program lines.

In this portion of the Discovery and Correction Phase, entities prepare the financial improvement plans for achieving an unqualified audit opinion of their financial statements. Entities also identify in their plans, by financial statement line item, all known deficiencies relating to the item, including accounts requiring correction and processes requiring improvement.

Let's learn more about what is involved in discovery.



Discovery and Correction (cont.)



Discovery (cont.):

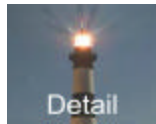
- **Identify material weaknesses.**
- **Prepare corrective action plans.**
- **Implement corrective action.**
- **Incorporate effective oversight.**



To prioritize corrective actions, managers should identify deficiencies that have a material impact on the financial statements. Management personnel then prepare comprehensive corrective action plans to resolve the identified deficiencies. Plans must identify how staff (human capital), processes, or business systems would be changed to implement corrective actions. Implemented plans must then incorporate effective oversight mechanisms to ensure that they are carried out and that the corrections are sustainable. Additionally, managers must base milestones on actual estimates of the effort required, and identify critical task dependencies.

The corrective action plans should include any requirement for systems audits that would need to be performed. Systems audits ensure that financial reporting systems are reliable. If current systems must be modified and the modifications are part of the corrective actions, management personnel prepare a business case to support the modification, submit the case to the BMMP Office, and advise the assigned OUSD(C) POC.

Let's explore some areas where problems are found.



Discovery and Correction (cont.)



Sources of Weaknesses:

- Audit/inspection reports
- Lessons learned
- Policy, procedure, and process reviews
- Hot-line reports
- Actual analysis



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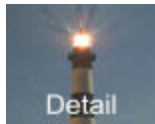
L3-23

Problems are found on audit and inspection reports, from lessons learned in similar organizations, or from reviews of policies, procedures, and processes. They are also discovered through analysis of financial information, documentation, and systems. The establishment of a hot-line to report deficiencies such as those used to capture fraud, waste, and abuse information, without fear of reprisal, may also be a source for the identification of material weaknesses.

Similar entities may experience problems in areas that were not found on previous inspections or audits of your entity. Reviewing the findings of other entities may provide areas of needed improvement in your entity.

Management reviews policies, procedures, and processes to ensure that they are compliant with legal and regulatory guidance, and that they ensure adequate controls over entity resources. New procedures may be required in the absence of pre-existing procedural guidance, especially in areas of high personnel turnover, complicated processes, or high-value asset use.

Let's continue with these sources.



Discovery and Correction (cont.)



Sources of Weaknesses (cont.):

- **Analyze transactions and balances.**
- **Trace transaction from origin to consolidation in financial statements.**
- **Use available resources to perform systems analysis.**

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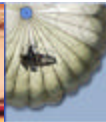
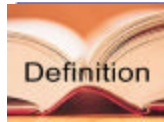
L3-24

Analysis of financial information, documentation, and systems is used to identify unusual balances or entries, document trails and areas of inadequate documentation, and system controls. Unusual balances or entries may be the result of failure of a policy, procedure, or control, or of fraud.

Instances of when complete documentation doesn't exist to be able to trace transactions from their origin to their consolidation into the financial statements must be identified. An analysis of the documentation required for transaction types assists in making this identification. Reversing the process traces a consolidated transaction to its origins. Auditors must be able to trace your transactions all the way to the originating documents. They must also be able to verify from those documents that amounts recorded on the financial statements are based on factual information, that adjustments made to that information are made using appropriate accounting practices, and that proper authorization exists at each level of the transaction.

Systems analysis may be accomplished using resources from outside of your entity. The Defense Information Systems Agency (DISA) is one source. Another is DFAS. Systems are analyzed to ensure that they are compatible with the future plans of the Department, and that they apply adequate controls for transaction authorization and separation of duties. They are also analyzed for their ability to provide meaningful financial information in a timely manner.

This leads to the second half of the Discovery and Correction Phase, correction.



Discovery and Correction (cont.)



Correction: requires DoD entities to implement solutions within the milestone dates prescribed, resulting in a resolution of the identified deficiency.

- Identify any new deficiencies.
- Modify plans to include any additions.
- Requests for extension of dates should include a plan for getting back on track to meet the next original milestone date.



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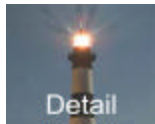
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L3-25

Correction requires DoD entities to implement solutions within the milestone dates prescribed, resulting in a resolution of the identified deficiency. Correction is a multi-faceted and incremental process. In other words, all corrective action steps are not expected to be completed on the same date. Management personnel and audit committees at each activity closely monitor progress to ensure that actions taken achieve the intended result in the time allotted.

As corrections are ongoing, it is anticipated that new deficiencies may be identified. As this occurs, activities coordinate with their OUSD(C) POC to modify plans to include any such additions. Requests for extension of dates should include actions taken to date, reason for date slippage, new proposed completion date, and a plan for getting back on track to meet the next original milestone date.

Let's consider these requirements.



Discovery and Correction (cont.)



Correction Requirements:

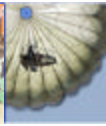
- **On time and incremental**
- **Resolves discrepancy**
- **Monitor progress and coordinate**
- **Extensions**

Corrective action plans must contain milestones and goals that are clearly measurable. Plans are incremental to allow for actions that may involve more than one entity. Management must assign tasks to responsible individuals in accordance with the corrective action plans and monitor progress. Individuals are held accountable for the accomplishment of their assigned tasks using a balanced scorecard approach.

As with many projects, problems may be encountered that require additional resources or time. Management may reassign resources or request assistance from outside sources. Identified problems may require action from other entities prior to correction of the original discrepancy. In such cases managers may re-organize actions that are not dependent upon the delayed processes to allow for the continuation of corrections.

As other entities may depend on the resolution of your original deficiency, it is important to coordinate with your OUSD(C) POC. Your POC works with you to identify resource requirements, coordinate schedules, and modify interim milestones. As mentioned earlier, you must have a plan for meeting the next original milestone.

Let's examine some practices used by others.



Discovery and Correction (cont.)



Best Practices:

- **Hold regular progress reviews.**
- **Know your deficiencies.**
- **Document responsibilities.**
- **Partner with DFAS.**
- **Use available assistance.**

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L3-27

Some suggestions of practices that have served well in similar organizations concerning discovery and correction are to have reviews regularly to check on how you are doing. As part of the monitoring process, reviews allow managers to identify resource requirements that may not have been anticipated in the corrective action plans. Reviews should have clear agendas and require responses from participants as to the status of their progress.

The best organizations know their deficiencies and assess their operations regularly. A recent practice within the Department is to brief midyear and end-of-year financial statements to the DoD Comptroller. According to the GAO and the DoDIG, the practice of preparing and explaining interim financial statements has improved the reliability of reported information through more timely discovery and correction of numerous recording and reporting errors. Correction can only begin from a position of knowledge.

You must document responsibilities and ensure that you have clearly communicated who must perform the action, what must be done, when it must be completed, and the expected result of that action. Successful organizations do not attempt to solve problems outside of their areas of expertise. DFAS is an invaluable source of assistance. Its employees are familiar with audit requirements and have in fact passed more than one financial statement audit. They are knowledgeable of financial reporting requirements, documentation requirements, financial systems and their capabilities, and financial management trends. They may provide assistance in analysis of financial transactions and balances, and may be able to explain unusual transactions that affect your financial statements.

Audit agencies may provide assistance with analysis and historical audit records.



Validation



Validation Phase:

Management validates financial information after corrective actions are completed.

Why	How
Implement 1008, enhance credibility of assertions, validate corrections	First, management coordinates with DoDIG and notifies RPS. Second, management documents processes, identifies controls and systems, and ensures that supporting documentation is available. Third, management requests validation of financial information.

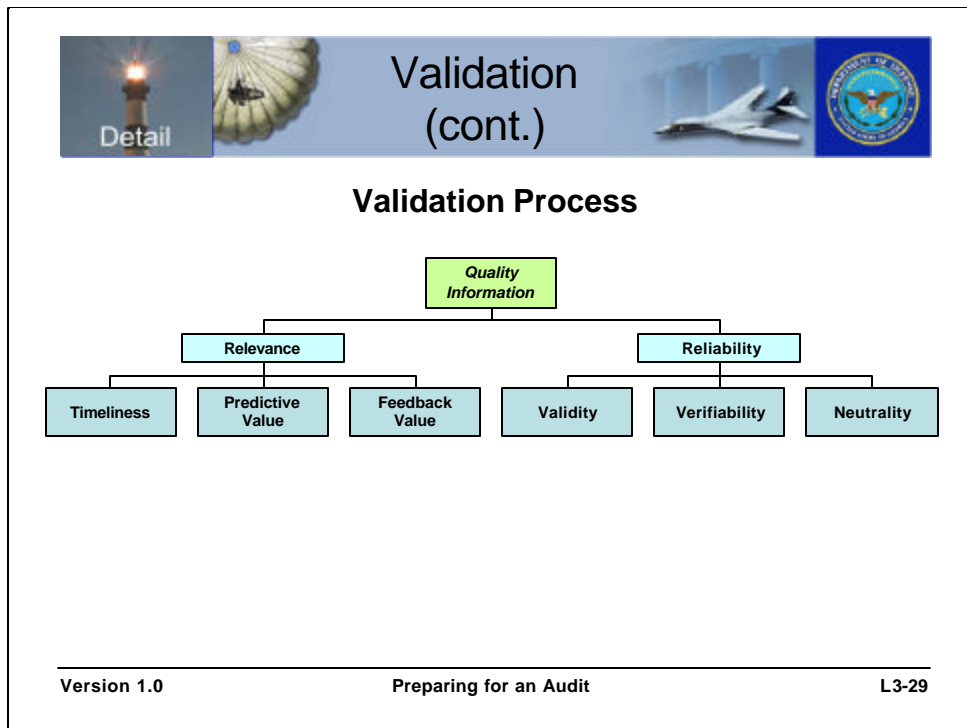
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L3-28

The purpose of the Validation Phase is to validate the effectiveness of the corrective actions. It is accomplished through coordination with the DoDIG and their RPS. Validation determines whether sufficient controls and transaction information are available to support management's assertion that the line or statement is ready for audit, and ensures that supporting documentation is available for audit.

A validation is a limited scope evaluation or review to determine whether previously identified deficiencies in an entity's financial statements or line items have been satisfactorily remedied. This review is the responsibility of management and may be performed by management, internal auditors, or a contractor under the supervision of management. The scope of specific procedures required for each validation are also the responsibility of management and are determined in the context of the materiality of each issue or action taken.



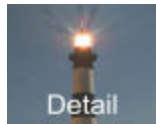
At the beginning of the Validation Phase, entities notify the DoDIG by memorandum, with a copy furnished to the entity's OUSD(C) POC, of the entity's intent to validate a line or statement and the corrective actions taken to resolve deficiencies. It is important to tell the DoDIG what you plan to do. The DoDIG must be aware of the validation technique being performed by the entity prior to the initiation of the validation process to facilitate the assessment process after the entity submits its assertion package. Although the DoDIG has no specific role in the validation, the DoDIG may, in an advisory capacity, comment on any obvious flaws or items of concern related to the validation methodology.

The OUSD(C) POC then notifies the RPS. The RPS notifies the ESC, and, if any concerns exist, the ESC provides a memorandum to the entity conveying its concerns.

The notification includes the intended method for validating that the corrective action corrected the known deficiency, and that the line or statement is ready for audit. Once required notification is sent, and validation methods are planned, the validation process begins.

The validation process is primarily for management to determine whether a particular statement or line is ready for an assessment or audit by the DoDIG. To be audit-ready, information provided in the statement or line must be both relevant and reliable. Relevance is related to the usefulness of the information, such as its timeliness, predictive value, or feedback value. Reliability relates to the accuracy of the information. To be reliable, the information must be valid, verifiable, and unbiased or neutral. If management determines that the statement or line is ready, the work accomplished during validation may be used by the DoDIG.

Let's discuss the actions required in this phase.



Validation (cont.)



Assertion Package Organization and Review Criteria

TAB	TOPIC	Checklist Step
1	Process Cycle Memos and Flow Charts	1
2	GL Transaction Detail/Support	2
3	Evidential Matter	3
4	Validation Summary (Management Assertion Letter, Completed Assertion Checklist, and Validation Work Products such as completed GAO Checklists, etc)	4
5	Status of FIP Corrective Actions	5
6	Summary of Corrective Actions Taken	6
7	Organization Charts/Contact Lists	7
8	FISCAM and SAS 70/88 Audit Date and POCs	8
9	FISCAM and SAS 70/88 Audit Results	9
10	Hardware, Software, and Interfaces	10
11	Type of Data Produced	11
12	Telecom/Network Information	12
13	Certifications/Accreditations	13
14	System/End User Locations	14
15	Location of Systems Documentation	15
16	Data Type/Summary of Transactions (Number, Type, Dollar Value)	16
17	List of Authorized Users	17
18	List of On-Going or Planned Reviews	18

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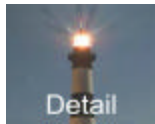
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L3-30

During the Validation Phase, the entity performs a validation of the resolution of the identified deficiencies. These validations are performed at the request and under the oversight of management. Audit committees within the entity should be actively engaged in overseeing the progress of the validation process.

At this time management completes a checklist that is required for the assertion package. The checklist includes such steps as documenting processes, identifying controls and systems, and ensuring that supporting documentation is available. This checklist and accompanying assertion information is used later during the Assessment and Audit Phases, and may be viewed in Appendix B, Assertion Package Organization and Review Criteria.

Notice that the checklist begins with the topic Process Cycle Memos and Flow Charts. To use the checklist, you must read the accompanying instructions that provide a full description of what is required to fulfill the checklist item. Let's examine the first item to demonstrate the use of this validation tool.



Validation (cont.)



Requirements for Checklist Item 1: Process Cycle Memos and Flow Charts

- **Identify and document the procedures, processes, and control points for deriving the balances.**
- **Include the systems that are used and the flow of data from field level/installation to departmental level.**
- **Identify all systems that have detail that make up the balances.**

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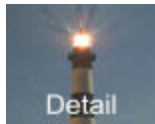
L3-31

In Processing Cycle Memos and Flow Charts, the user needs to identify and document the procedures, processes, and control points for deriving the balance or balances being asserted. The user needs to include the systems that are used and the flow of data from field level or installation to departmental level.

This can be done in a cycle memorandum or flow chart format. Having this information prepared in advance will be a great tool for you to refer to during the assessment and audit. This information will also be used by the auditor as part of the audit so you will already have the information prepared. Be sure to identify all systems that have detail that make up the balances being asserted as ready for audit.

Earlier we covered the need to identify and document the procedures, processes, and controls within your entity. This process began in the Discovery and Correction Phase while you were working on the identification of problems and planning corrective actions. It continues and is completed in the Validation Phase.

The instructions also include the criteria used to evaluate whether or not the required action was satisfactorily completed. Let's look at these criteria.



Validation (cont.)



Evaluation Criteria for Process Cycle Memos and Flow Charts:

- **Accurately describe the regulations followed for the process.**
- **Document procedures utilized.**
- **Document key control techniques.**
- **Identify systems used at the departmental level.**
- **Include the management control objectives and risk assessments.**

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L3-32

The evaluation criteria for processing cycle memos and flow charts state that a flowchart is required for each major process and a cycle/process memorandum should be provided to:

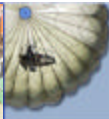
- accurately describe the regulations followed for the process
- document procedures utilized
- document key control techniques identify systems used at the departmental level
- include the management control objectives and risk assessments.

Control techniques/activities are those activities that work to ensure that resources are used consistent with laws, regulation, and policies; are safeguarded against waste, loss, and misuse; and reliable data is obtained, maintained, and disclosed in reports. Examples include passwords, separation of duties, physical security, and adequate supervision among many others.

You should review the flowcharts, cycle/process memorandum, and supporting documents for reasonableness and completeness for each process listed.

The GAO/PCIE FAM Section 390.04, Cycle Memorandum and Flowchart, describes a cycle memorandum. Use of this manual was discussed in Lesson 2, Auditable Data and Audit Methodology. More information on the requirements for cycle memorandum and flowcharts is available in the Evidential Matter course.

Let's consider a few helpful practices.



Validation (cont.)



Helpful Practices in the Validation Phase:

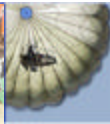
- **Think like an auditor.**
- **Have a good method for organizing documentation, and use document review products such as EDA.**
- **Establish clear audit trails and keep a copy of the databases.**

There are a few helpful practices that may assist you in the validation process. To begin, you must think like an auditor. This includes the use of audit checklists, references, and tools that an auditor would use to assess the information that you supply. Procedures used by auditors rarely call for in-depth analysis or complicated calculations. Audit opinions are based on solid research of your policies, practices, and procedures, and the resultant financial information you report.

To ensure that others may reach the same conclusion, using the same data set and validation methods, a good method for organizing documentation is needed. Products such as Electronic Document Access (EDA) can help in reviewing documents.

Organizations that obtain favorable audit opinions have established clear audit trails. Once audit trails are established, records of tests of documentation procedures can be maintained to substantiate audit readiness. It is a good idea to keep a copy of the databases used in your analysis of financial information. Conclusions drawn using a particular set of data may not be valid when the data changes during the next accounting cycle, though the procedures for gathering that data should not change from one period to the next.

Let's discuss a couple more practices.



Validation (cont.)



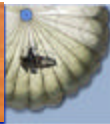
Helpful Practices in the Validation Phase (cont.):

- **Ensure top management involvement and establish an audit committee or audit interest group.**
- **Have good report writers.**

Top management involvement is critical, and having an audit committee or audit interest group ensures that those personnel who must answer audit inquiries are involved in the process. By their involvement, top management emphasizes the importance of the effort.

Remember that top management may not have time to review detailed technical data. You must have good report writers to summarize the data presented by technicians and analysts.

Now let's look at the Assertion Phase.



Assertion



Assertion Phase:

Management affirms to DoDIG the reliability of the financial information.

Why	How
Communicate to DoDIG and auditors the reliability of financial information.	Assertion letter to DoDIG, checklist, and results of validation and reports; engagement letter and management representative letter, if used; memo to DoDIG, copy to OUSD(C) RPS; ESC approval required for assessment or audit

The purpose of the Assertion Phase is to notify the DoDIG that validation of corrected deficiencies has been completed and that a financial statement or line item is ready for audit. During the Assertion Phase, management prepares an assertion memorandum stating audit readiness and a package of accompanying documentation to support the position of audit readiness.

Let's learn more about this phase.



Assertion (cont.)



Assertion Package:

- **Management assertion letter**
- **Summary of the validation work performed**
- **Assertion checklist**

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The assertion package is submitted to DoDIG, with a copy furnished to the OUSD(C) POC, who forwards it to the RPS.

The assertion package contains:

- the management assertion letter
- a summary of the validation work performed that contains an explanation of actions taken by management to resolve deficiencies, and reports resulting from validation
- the assertion checklist that was completed during the Validation Phase.

If the entity prepares an engagement letter or a management representation letter for the DoDIG, subsequent representation letters should reflect management's assertions in them.

Let's look at each of these documents.





		<h2>Assertion (cont.)</h2>												
<h3>Example Management Assertion Letter</h3>														
<table border="1" style="width: 100%;"> <tr> <td colspan="2" style="text-align: center;">Organization name and address</td> </tr> <tr> <td style="width: 60%;">Office symbol</td> <td style="width: 40%;">Date stamp</td> </tr> <tr> <td colspan="2">Memorandum For (Organization Comptroller)</td> </tr> <tr> <td colspan="2">Subject: Management Assertion for (Named fund)</td> </tr> <tr> <td colspan="2"> <p>We are asserting that (Named fund) is auditable and we have completed corrective actions on material deficiencies for the (Named fund) line item on the balance sheet. (Named fund) is fairly presented in accordance with generally accepted accounting principles and is ready for audit. We are providing the completed assertion checklist information in the packet supporting our preparedness.</p> <p>We completed the actions to correct the known material deficiencies as articulated in (source document). The specific actions taken to correct the material deficiencies can be found in (file name and location) of the assertion packet. Additional actions were completed to ensure adequate controls are in place to meet auditor documentation requirements and we received assurances of auditability from (source of assurance).</p> <p>Sufficient audit-ready evidential matter is available to support the transactions that</p> </td> </tr> </table>					Organization name and address		Office symbol	Date stamp	Memorandum For (Organization Comptroller)		Subject: Management Assertion for (Named fund)		<p>We are asserting that (Named fund) is auditable and we have completed corrective actions on material deficiencies for the (Named fund) line item on the balance sheet. (Named fund) is fairly presented in accordance with generally accepted accounting principles and is ready for audit. We are providing the completed assertion checklist information in the packet supporting our preparedness.</p> <p>We completed the actions to correct the known material deficiencies as articulated in (source document). The specific actions taken to correct the material deficiencies can be found in (file name and location) of the assertion packet. Additional actions were completed to ensure adequate controls are in place to meet auditor documentation requirements and we received assurances of auditability from (source of assurance).</p> <p>Sufficient audit-ready evidential matter is available to support the transactions that</p>	
Organization name and address														
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Memorandum For (Organization Comptroller)														
Subject: Management Assertion for (Named fund)														
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In this sample management assertion letter, the organization is asserting that the named fund is auditable and that material deficiencies concerning that line item have been corrected. The assertion also states that the line item is fairly presented in accordance with generally accepted accounting principles and is ready for audit.

It then states the items included in the assertion packet that support this assertion.





The assertion letter contains the required assurance that sufficient audit-ready evidential matter is available to support the transactions that constitute the named fund, and the assurance that sufficient knowledgeable staff is available to support audit requests during audit fieldwork.

The next item is the Validation information that includes a Validation Certification and the Validation Summary. Let's take a look at those documents.

Assertion (cont.)					
 <p>Example Validation Certification</p>	<div>    </div>				
	<table border="1"> <tr> <td>Organization</td> <td>Section Reference</td> </tr> <tr> <td></td> <td>Validation Certification</td> </tr> </table>	Organization	Section Reference		Validation Certification
	Organization	Section Reference			
		Validation Certification			
<table border="1"> <tr> <td>Client</td> <td>Date</td> </tr> <tr> <td>Named Fund</td> <td>Typed Date</td> </tr> </table>	Client	Date	Named Fund	Typed Date	
Client	Date				
Named Fund	Typed Date				
<p>This document is to inform the Under Secretary of Defense (Comptroller), Department name, and Department of Defense Inspector General that the Named fund assertion packet meets all of the requirements set forth in the Under Secretary of Defense (Comptroller) memorandum "financial Improvement Business Rules," dated June 23, 2004 and "Financial Improvement Initiative Assertion Package Criteria and Organization," dated November 15, 2004. All supporting documentation has been compiled and presented as required as is available to view on the (file location and name).</p> <p>Preparer: PREPARERS SIGNATURE</p> <p>Supervisor Review SUPERVISORS SIGNATURE</p> <p>Director of Departmental Accounting Review:</p>					
<div> <div>Version 1.0</div> <div>Preparing for an Audit</div> <div>L3-38</div> </div>					

In the example of the Validation Certification, the preparer, reviewers, and other members of management annotate with their signatures that the named fund assertion packet meets all of the requirements set forth in the USD(C) memorandum concerning the Financial Improvement Initiative Business Rules and the memorandum subject Assertion Package Criteria and Organization. They assert that all supporting documentation has been completed and presented as required and is available to view at a specific file location.

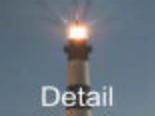



Now let's look at the Validation Summary.

<div>   <div>Assertion (cont.)</div>   </div>					
<div>Example Validation Summary</div>	<div> <div>Organization</div> <div>Executive Summary – Fund Name Assertion Packet</div> </div>				
	<table border="1"> <thead> <tr> <th>Client</th> <th>Date</th> </tr> </thead> <tbody> <tr> <td>Fund Name</td> <td>November 30, 2004</td> </tr> </tbody> </table>	Client	Date	Fund Name	November 30, 2004
	Client	Date			
	Fund Name	November 30, 2004			
<p>Organization Name is asserting that the Fund Name and specific line item is ready for audit and balances reported in the quarterly and year-end financial statements are fairly presented in accordance with generally accepted accounting principles. Over the past five years the Organization has implemented several initiatives to improve the accountability over the execution and reporting of Fund name. These initiatives improved controls, increased the efficiency and timeliness of recording undistributed disbursements and collections in accounting systems, improved documentation, and reduced risk in the financial reporting process. These actions have put the organization in a position that with alternative auditing procedures the Fund name Balance Sheet line item (\$xx.x billion) is ready for an audit.</p> <p>Composition of Fund name</p> <p>The organization receives the majority of funds in the form of direct appropriations (\$xxx.x billion), as passed by Congress in the Annual Appropriation Acts passed by Congress. These are apportioned by the Office of Management and Budget (OMB), and recorded on the basis of the U. S. Treasury issuing a Warrant to the Organization. The funding business rules impacting Fund name have been auditable for a number of years. The organization's Fund name is decremented, or supplemented by reimbursable activity (\$xx.x billion), by the recording of disbursements and collections at the U. S. Treasury. Organization has implemented several improvements since FY 2000 to ensure the timely recording of disbursements and collections (Net Outlays \$xxx.x billion) and to improve documentation. These actions lead the Organization to consider the Fund name to be considered auditable.</p> <p>Improved Controls</p> <p>The Organization Disbursing Network originally consisted of over XX disbursing activities processing over XXX fiscal stations. This structure caused enormous inconsistencies in business practices, large reconciliation issues, and minimal management control. To improve control, the network was consolidated into two</p>					
<div> <div>Version 1.0</div> <div>Preparing for an Audit</div> <div>L3-39</div> </div>					

The Validation Summary outlines the corrective actions taken to improve accountability, controls, efficiency, timeliness, and documentation for the fund or balance being reported. It then states that the item is ready for an audit.

It may provide an overview of the fund prior to listing specific actions performed by the entity to prepare the fund or balance for audit. This is an area where accomplishments of the entity are highlighted and good report writing is essential.

Let's talk about the completed assertion checklist.

  <h1 style="text-align: center;">Assertion (cont.)</h1>  			
<h2 style="margin: 0;">Assertion Checklist</h2>	Organization Section III Assertion Packet Checklist		
	Prepared by	Client	Date
	Typed name	Named fund or entity	November 30, 2004
	<div style="display: flex; align-items: flex-start;"> <div style="border: 1px solid black; padding: 2px; margin-right: 5px; text-align: center;"> <input checked="" type="checkbox"/> </div> <div> <p>Identify and document the procedures, processes, and control point for deriving the balances being asserted. Include the systems that are used and the flow of data from field level to departmental level.</p> <p>RESPONSE: The procedures, processes, and control points are documented in the Process Analysis Document (PAD) and the Audit Folders. The PAD provides a high level overall flow of the Named Fund processes, information on the computer systems used, and process-level risks and controls. See Attachment A for a copy of the PAD. In addition, the Assertion Folders provide detailed documentation on each of the individual processes within the PAD to include listings of the incoming and outgoing reports, point of contacts, control points, risk areas, assumptions, and examples. See Attachment B for a list of all the Assertion Folders. Due to the volume, the folders are included in the assertion packet on the CD and on the file location and name."</p> <p>In addition, Attachment C provides a methodology for audit planning. This provides suggestions for planning the named fund audit based on requirements set in the Governmental Accountability Office Financial Audit Manual and entity knowledge.</p> </div> </div>		
<div style="display: flex; align-items: flex-start;"> <div style="border: 1px solid black; padding: 2px; margin-right: 5px; text-align: center;"> <input checked="" type="checkbox"/> </div> <div> <p>1. Have all General Ledger transaction detail and supporting information from feeder systems available for all the transactions that make up the balance being asserted. Ensure the total of the detail equals the balance of the line item. This includes all accounting adjustments that have an effect on the ending balance of a line item reported on the financial statements</p> <p>RESPONSE: Attachment D provides a list of all the transaction files, the POC, the location of "</p> </div> </div>			
<div style="display: flex; justify-content: space-between;"> Version 1.0 Preparing for an Audit L3-40 </div>			

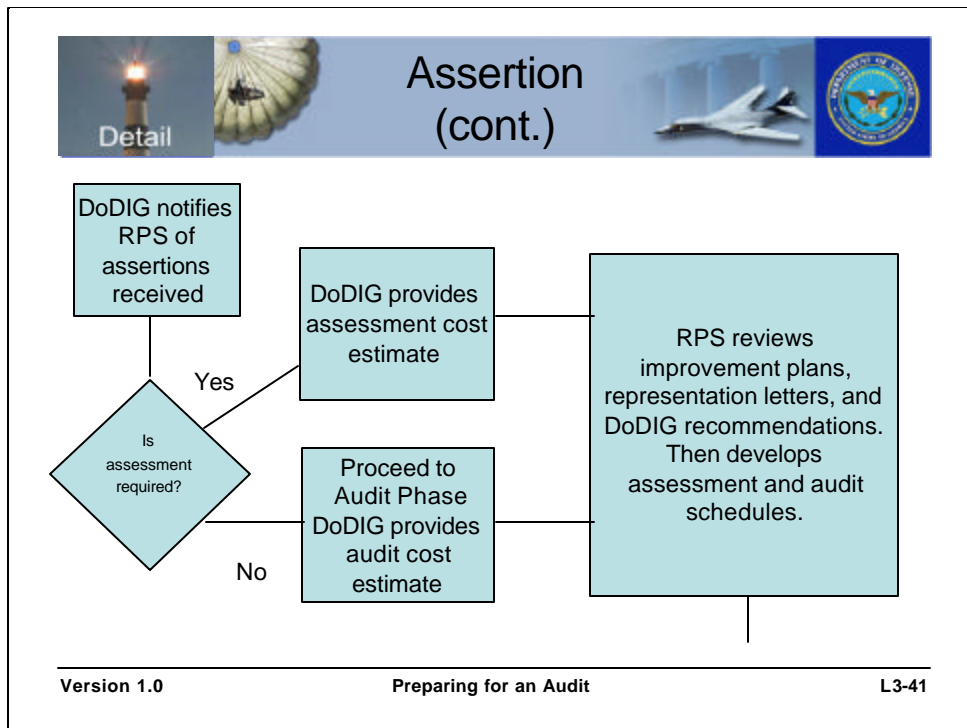
The completed assertion checklist provides a description of each topic and the entity's response to the requirements for its validation.

Notice that the topic Process Cycle Memos and Flow Charts requires the entity to identify and document the procedures, processes, and control points for deriving the balances being asserted. The corresponding response states the specific document and location where the procedures, processes, and controls are documented.

The assertion process should include the specific systems relationship between the line being asserted and all financial management systems and associated feeder systems.

For new systems that may not have previously identified problems, there is a requirement to include the CFO Act fourteen point checklist for new systems or for each system in the assertion.

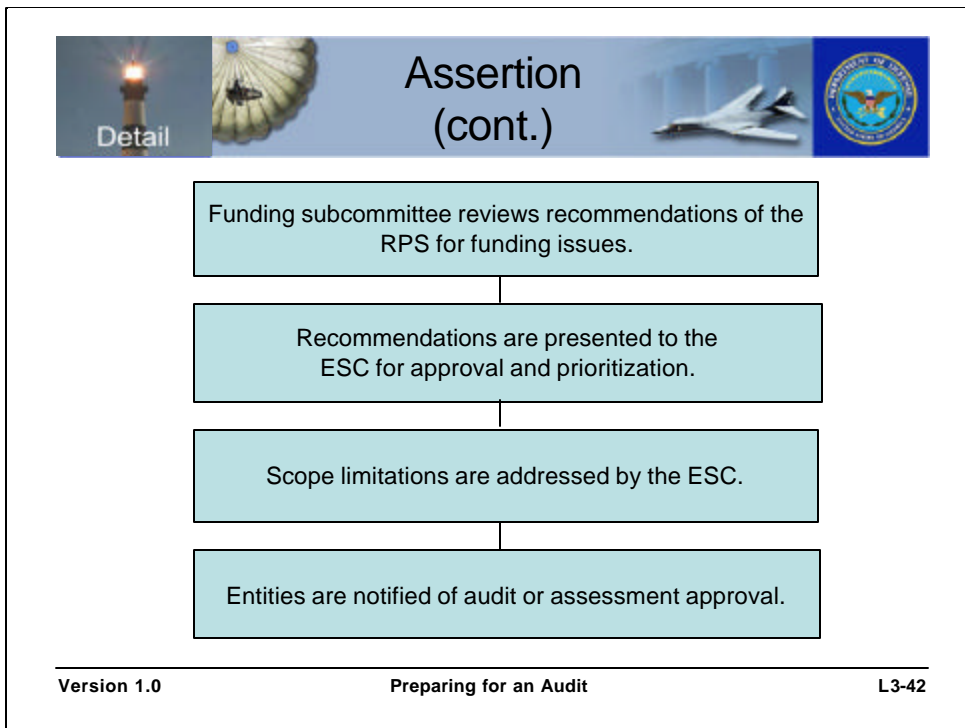
Now let's discuss the distribution of and action taken on these documents.



The DoDIG receives the assertion package and determines, based on the information in the package and other pertinent knowledge, whether it will conduct an assessment of the entity's line or statement or whether it will bypass the Assessment Phase and proceed to the Audit Phase IAW Section 1008. The DoDIG notifies the Review and Prioritization Subcommittee of the assertions received and advises the committee if the assertion letter will result in an assessment or an audit.

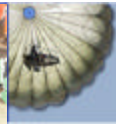
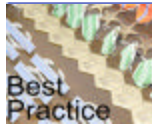
The DoDIG then provides a cost estimate for the assessment or audit.

The RPS reviews improvement plans, representation letters, and DoDIG recommendations and develops prioritized recommendations for assessment and audit schedules to present to the ESC.



The Funding Subcommittee also reviews the recommendations of the RPS for funding issues. The recommendations for assessment and audit are presented to the Financial Management Improvement Plan ESC for approval and prioritization. Recommendations presented to the ESC address scope limitations that may be imposed on the assessments or audits. Entities are then notified when they are approved for assessment or audit.

Let's look at an example of a good assertion documenting process.



Assertion (cont.)



Develop a method of organized folders.

Army Financial Statement Assertions are on the DFAS ePortal.



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To save time and audit cost, it is important to develop a method of organizing folders so that all assertion data can be retrieved and reviewed quickly and efficiently.

One example of this process is the Army Financial Statement Assertions on the DFAS ePortal. Folders are set up for each of the affected financial statements. Within each statement folder, subfolders are set up for various line items such as Accounts Payable, Cash, Fund Balance with Treasury, and others.

Each line item is further subdivided by fund or other applicable division. In the case of Fund Balance with Treasury, it is subdivided into folders for the Army General Fund and the Army Working Capital Fund. Once the fund is selected, a subfolder containing Fund Balance with Treasury assertion packet information may be opened.

Subfolders in this area are divided into assertion or audit files. Assertion files include a table of contents file and numbered files that are labeled by section and title. Audit files are labeled by agency and title or report number of the audit reports.

Now let's examine the Assessment Phase.



Assessment



Assessment Phase:

The DoDIG reviews financial information to determine if it is ready for audit.

Why	How
Implements 1008, allows remediation, attests to management assertion, plans audit, reduces risk of unknowns to auditor, auditors' introduction to organization	DoDIG oversight of IPAs or DoDIG in-house assessments

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The purpose of the Assessment Phase is to determine the reliability of the line or statement that the entity asserted as being ready for audit.

This assessment is substantially less than an audit, but should be sufficient enough to verify that the corrective actions implemented during the Discovery and Correction Phase of the financial improvement initiative were successful.

Assessment is generally done first if a statement has never been audited. Assessment could also occur when the DoDIG believes circumstances may exist that would cause the entity to obtain an opinion other than an unqualified. An example of such a situation is a system of internal control allowing for the disbursement of funds without proper certification. In this case, the DoDIG would determine that an assessment is necessary to ensure reliability as required per Section 1008. During the Assessment Phase, an entity may perform a remedy in the event a deficiency is identified that would prevent an unqualified opinion.

Let's continue with this phase.



Assessment (cont.)



The scope of the assessment consists of accomplishing the audit steps outlined in the Planning Phase and Internal Control Phase of the audit manual.



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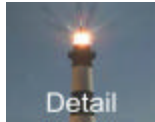
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The assessment is performed by the DoDIG, or by an independent public accountant contracted to perform work for the DoDIG, after the ESC has approved the assessment. The scope of the assessment is determined in accordance with the GAO/PCIE FAM and consists of accomplishing the audit steps outlined in the Planning Phase and Internal Control Phase of the audit manual. The assessment process determines whether the entity can likely achieve an unqualified audit opinion. If it is determined that circumstances or problems exist that preclude an unqualified opinion, a report is written to management that describes what has prevented the auditor from obtaining sufficient, reliable, and competent information. The report recommends to management what needs to be accomplished to remedy the problems.

The Assessment Phase is used as part of the DoDIG's audit strategy to reduce risks of the unknown and introduce new auditors to the entity's processes. Progress is reviewed and monitored by management and the entity's audit committee through regularly scheduled interim progress reports. Management informs its OUSD(C) POC of any new deficiencies identified. There is continued communication, both written and oral, as the assessment progresses. Management should take actions to correct problems identified during the assessment. The DoDIG recommends when it is appropriate to move forward with a formal audit.

Let's look at a few of the audit steps outlined in the Planning Phase and Internal Control Phase of the audit manual.



Assessment (cont.)



Financial Audit Manual Planning Phase

200	PLANNING PHASE
210	Overview
220	Understand the Entity's Operations
225	Perform Preliminary Analytical Procedures
230	Determine Planning, Design, and Test Materiality
235	Identify Significant Line Items, Accounts, Assertions, and RSSI
240	Identify Significant Cycles, Accounting Applications, and Financial Management Systems
245	Identify Significant Provisions of Laws and Regulations
250	Identify Relevant Budget Restrictions
260	Identify Risk Factors
270	Determine Likelihood of Effective Information System Controls

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The Planning Phase requires auditors to gain an understanding of the entity's operations, perform preliminary analytical procedures, and determine planning, design, and test materiality. Auditors must also identify significant line items, accounts, and assertions. In gaining an understanding of the entity's operations, auditors identify significant cycles, accounting applications, and financial management systems. They also familiarize themselves with the provisions of laws and regulations, and budget restrictions. Auditors evaluate risk factors and determine the likelihood of effective information systems controls, then identify relevant operations controls to evaluate and test.

Let's consider the identification of significant cycles, accounting applications, and financial management systems as listed in this manual.



Assessment (cont.)



Financial Audit Manual Planning Phase (cont.)

Planning Phase

240 - IDENTIFY SIGNIFICANT CYCLES, ACCOUNTING APPLICATIONS, AND FINANCIAL MANAGEMENT SYSTEMS

- .01 In the internal control phase, the auditor evaluates controls for each significant cycle and accounting application and determines whether significant financial management systems substantially comply with federal financial management systems requirements, federal accounting standards, and the SGL at the transaction level. A cycle or an accounting application should be considered significant if it processes an amount of transactions in excess of design materiality or if it supports a significant account balance in the financial statements or significant RSSI. A financial management system generally consists of one or more accounting applications. If one or more of the accounting applications making up a financial management system are considered significant, then that financial management system generally should be considered significant for determining whether the system substantially complies with FFMIA requirements. The auditor may identify other cycles, accounting applications, or financial management systems as significant based on qualitative considerations. For example, financial management systems covered by FFMIA include not only systems involved in processing financial transactions and preparing financial statements, but also systems supporting financial planning, management reporting, or budgeting activities, systems accumulating and reporting cost information, and the financial portion of mixed systems, such as benefit payment, logistics, personnel, and acquisition systems.
- .02 The entity's accounting system may be viewed as consisting of logical groupings of related transactions and activities, or accounting applications.

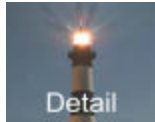
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The Financial Audit Manual describes the identification of significant cycles, accounting applications, and financial management systems requirements by providing an overview of the auditors' duties as they relate to this item. It defines significance as it relates to each item and how the items are affected by both financial and non-financial systems.

Now let's talk about the Internal Control Phase.



Assessment (cont.)



Financial Audit Manual Internal Control Phase

300	INTERNAL CONTROL PHASE
310	Overview
320	Understand Information Systems
330	Identify Control Objectives
340	Identify and Understand Relevant Control Activities
350	Determine the Nature, Timing, and Extent of Control Tests and of Tests for Systems' Compliance with FFMA Requirements
360	Perform Nonsampling Control Tests and Tests for Systems' Compliance with FFMA Requirements
370	Assess Controls on a Preliminary Basis
380	Other Considerations
390	Documentation



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The Internal Control Phase requires auditors to gain an understanding of the entity's information systems, control objectives, and relevant control activities. They must determine the nature, timing, and extent of control tests and of tests for systems compliance with legal requirements. To determine the testing required, auditors perform control and compliance testing on a preliminary basis.

Let's take a closer look at identifying and understanding relevant control activities.

Assessment (cont.)

Financial Audit Manual

Internal Control Phase (cont.)

Internal Control Phase

340 - IDENTIFY AND UNDERSTAND RELEVANT CONTROL ACTIVITIES

.01 For each control objective, based on discussions with entity personnel, the auditor should identify the control activities designed and implemented to achieve the specific control objective.¹ Such controls may be recorded in the auditor's informal notes and/or interview write-ups for use in the following procedure, but each control activity need not be formally documented on the SCE worksheet at this time. The auditor should first screen the activities to identify those that are effective and efficient to test. An IS auditor may assist the auditor in identifying and understanding IS controls.

BASIC UNDERSTANDING OF EFFECTIVENESS OF CONTROL ACTIVITIES

.02 The auditor should obtain a sufficient understanding of the identified control activities to determine whether they are likely to achieve the control objectives, assuming an effective control environment, risk assessment, communication, and monitoring, appropriate segregation of duties, and effective general controls. The purpose of this assumption is to identify any weaknesses in the specific control activities that should be corrected. When other internal control components are poor, there is inadequate segregation of duties, or poor general controls preclude the effectiveness of specific control activities that would otherwise be effective, the testing of such specific control activities may be limited to determining whether such controls are in place. To accomplish this, the auditor might (1) discuss the cycle and specific controls with management and then (2) perform walkthroughs by observing the controls in place or examining several items

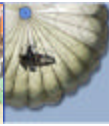
FACTORS TO CONSIDER

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Relevant control activities are described as those that are designed to achieve the specific control objective. The auditor first screens the activities to identify those objectives that are effective and efficient to test in an effort to obtain a sufficient understanding of the identified control activities. The auditor must determine whether he or she is likely to achieve the control objectives, assuming an effective control environment, risk assessment, communications, monitoring, appropriate segregation of duties, and effective general controls.

The auditor identifies any weaknesses in specific control activities that should be corrected. When internal control components are poor, there is inadequate segregation of duties, or poor general controls preclude the effectiveness of specific control activities that would otherwise be effective, the testing of these control activities may be limited to determining whether they are in place.

Let's examine a few practices that are particularly useful in the Assessment Phase.



Assessment (cont.)



Best Practices during the Assessment Phase:

- **Know the audit process and the regulations driving it.**
- **Have good training and awareness for all staff.**
- **Change the mindset toward audits.**
- **Know the auditor's checklist.**
- **Staff resources to work with auditors.**

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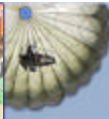
If you know the audit process and the regulations driving it, you can anticipate the auditor's requirements. It is important that good training and awareness for all staff is included in your assessment strategy. With adequate training on what is expected, you ensure that your people are ready for the audit.

You must lead a change in the mindset toward audits; they are not just for the financial community. You may set up a web site or have a newsletter. Frequent communication is necessary to convey expectations, goals, and direction.

When the auditors examine entity operations, you should know the auditor's checklist. You can then anticipate what is going to be needed and start early to have the audit move quickly and have less disruption of business operations.

Successful organizations ensure that they have adequate resources in place to assist in the audit effort. You must assign resources to work with auditors or hire contractors.

Let's continue with a few more practices.



Assessment (cont.)



Best Practices during the Assessment Phase (cont.):

- **Have the right people in the jobs.**
- **Have document retrieval methods documented.**
- **Have consistent practices.**

Having the right people in the jobs is critical to the audit effort. If not, the process slows down considerably. Auditors will ask the most available person questions concerning your entity's operations, controls, and procedures. You must ensure that the most available person is also the most knowledgeable person.

Document retrieval methods may be established for both paper and electronic documents. You must have document retrieval methods established and documented, especially for historical data. Ledgers containing all transactions should be ready and should include all documentation and back-up matter. This matter may include purchase orders, invoices, receiving reports, and other essential documentation. This source documentation may be located in several different offices. It must be pulled together to support the financial records.

Auditors are looking for consistent practices that are within established guidelines.

Let's move on to the Audit Phase.



Audit



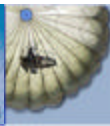
Audit Phase:

The DoDIG audits the organization's financial statements that management asserted were ready for audit and that passed the DoDIG assessment.

Why	How
Implement CFO Act, implement 1008, Presidents' Management Agenda.	Pass assessment, DoDIG oversight of IPAs or DoDIG in-house audits

The purpose of the Audit Phase is to obtain an auditor's opinion of the condition of an entity's financial statement or line. The purpose of this phase is also to obtain an auditor's opinion of the fairness of the presentation of the information in the financial statements. When a financial statement or portion thereof is asserted to be ready for audit and has passed assessment, or assessment has been waived, the DoDIG determines the appropriate scope and nature for a financial audit and the associated reports.

Let's learn more about this phase.



Audit (cont.)



The scope of the Audit Phase consists of accomplishing the audit steps outlined in the Testing Phase and Reporting Phase of the audit manual.



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During the Audit Phase, the entity and its accounting records are audited to determine if the balances and related notes presented on its financial statements fairly represent the operations of the entity.

With the assistance of the DoDIG, DoD reporting entities prepare detailed engagement letters requesting audit services. The auditors then require any management representations made to date that concern the items to be included in the audit. DoD reporting entities prepare as many interim management representation letters as necessary to include any additional assertions required by the audit. They then prepare a final management representation letter.

Management personnel address deficiencies with a written plan for resolution, including projected resolution date. The DoDIG intervenes if necessary to end the audit and recommends a follow-up assessment upon indication that the audit may not have a favorable outcome.

The scope of the Audit Phase consists of accomplishing the audit steps outlined in the Testing Phase and Reporting Phase of the audit manual.

Let's look at a few of these steps.



Audit (cont.)



Testing Phase:

- **Auditors consider the nature, timing, and extent of tests.**
- **Tests must provide the greatest benefit for the least amount of time and resources.**

400	TESTING PHASE
410	Overview
420	Consider the Nature, Timing, and Extent of Tests
430	Design Efficient Tests
440	Perform Tests and Evaluate Results
450	Sampling Control Tests
460	Compliance Tests
470	Substantive Tests – Overview
475	Substantive Analytical Procedures
480	Substantive Detail Tests
490	Documentation

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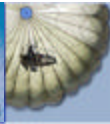
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The Testing Phase consists of a consideration of the nature, timing, and extent of tests to be performed on the evidentiary matter associated with the audit. The auditor must design efficient tests that provide the greatest benefit for the least amount of time and resources. The auditor must then perform those tests and evaluate results. Several types of testing are available and are explained within the FAM. The Evidential Matter course provides additional information concerning audit testing methods.

Once testing is completed, the auditor must document the results in order to ensure that adequate audit procedures have been accomplished.

Let's look at the requirement for performing tests and evaluating results.



Audit (cont.)



Testing Phase (cont.):

- Tests should evaluate the results of each type of test separately.
- Tests performed with the expectation of obtaining certain results may give other results.

Testing Phase

440 - PERFORM TESTS AND EVALUATE RESULTS

- .01 The auditor should perform the planned tests and should evaluate the results of each type of test separately, without respect to whether the items were chosen as part of a multipurpose test. Guidance on performing and evaluating the results is presented for each type of test in the following sections
- Section 450 - Sampling control tests,
 - Section 460 - Compliance tests, and
 - Section 470 - Substantive tests.
- .02 Sometimes, tests performed with the expectation of obtaining certain results give other results. When this happens, the auditor may wish to expand a sample to test additional items. Unless planned for in advance, this generally cannot be done simply, as discussed in paragraphs 450.17, 460.02, and 480.28; the auditor should consult with the Statistician in such cases.

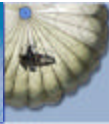
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Preparing for an Audit

L3-55

The FAM states that the auditor should perform the planned tests and should evaluate the results of each type of test separately, without respect to whether the items were chosen as part of a multipurpose test. It states that sometimes, tests performed with the expectation of obtaining certain results give other results. When this happens, the auditor may wish to expand a sample to test additional items. Unless planned for in advance, this generally cannot be done simply and the auditor should consult with a statistician.

Let's discuss the Reporting Phase now.



Audit (cont.)



Reporting Phase

500	REPORTING PHASE
510	Overview
520	Perform Overall Analytical Procedures
530	Determine Adequacy of Audit Procedures and Audit Scope
540	Evaluate Misstatements
550	Conclude Other Audit Procedures <ul style="list-style-type: none">• Inquiries of Attorneys• Subsequent Events• Management Representations• Related Party Transactions
560	Determine Conformity With Generally Accepted Accounting Principles
570	Determine Compliance With GAO/PCIE Financial Audit Manual
580	Draft Reports

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Preparing for an Audit

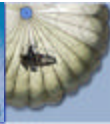
L3-56

The Reporting Phase requires the auditor to perform overall analytical procedures. This does not mean that all testing must be re-done, but that the results of all of the testing must be analyzed in order to formulate conclusions. The auditor must also determine the adequacy of audit procedures and the audit scope in the formulation of these conclusions.

Misstatements are evaluated for their severity. If material, they may affect the overall opinion of the auditor. Other audit procedures include inquiries of the attorneys who represent the entity. Auditors must determine whether there are any pending liabilities that were not adequately disclosed in the notes to the financial statements.

The auditor must determine whether the presentation of the financial statements is in conformity with GAAP and whether the entity is in compliance with the Financial Audit Manual. The auditor then drafts reports on the financial statements, internal control, financial management systems, and compliance with laws and regulations. The draft reports are used during the discussion of audit findings during the exit conference, though most items will have already been addressed throughout the audit.

Let's expand on the drafting of these reports.



Audit (cont.)



Reporting Phase:

Auditors reports include conclusions on:

- the financial statements
- internal controls
- compliance with laws, requirements, and standards.

Reporting Phase

580 - DRAFT REPORTS

- .01 At the conclusion of the audit, the auditor finalizes the draft of the auditor's report(s), which includes the auditor's conclusions on
- the financial statements (see paragraphs 580.10-.31);
 - internal control (see paragraphs 580.32-.61);
 - whether the financial management systems substantially comply with the requirements of FFMIA: federal financial management systems requirements, federal accounting standards (GAAP), and the SGL at the transaction level (see paragraphs 580.62-.66); and
 - compliance with laws and regulations (see paragraphs 580.67-.75);
 - the MD&A (see requirements in SFFAS No. 15) and other information included in the Accountability Report (including RSSI) (see paragraphs 580.76-.81).
- .02 The auditor's report should clearly identify the entity audited, the Accountability Report on which the auditor is reporting, and the period covered by the Accountability Report.
- .03 The report should be dated as of the completion of fieldwork. If a subsequent event occurs after that time that requires disclosure in the report, the auditor should follow the guidance in AU 530 with respect to dating the

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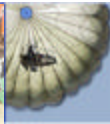
Preparing for an Audit

L3-57

At the conclusion of the audit, the auditor finalizes the draft of the auditor's reports. They include the auditor's conclusions on the financial statements, internal control, and system compliance with requirements of the FFMIA, federal financial management systems requirements, federal accounting standards, and the SGL at the transaction level. They also include the auditor's conclusions on the entity's compliance with laws and regulations.

The auditor's report should clearly identify the entity audited, the accountability report on which the auditor is reporting, and the period covered by the accountability report. It should then be dated as of the completion of fieldwork.

Let's consider a few helpful practices.



Audit (cont.)



Best Practices during the Conduct of the Audit:

- **Plan the entrance conference.**
- **Maintain communications with POCs and employees.**
- **Monitor information consistently and keep track.**

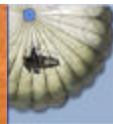
These practices are particularly helpful during the conduct of an audit.

An audit should contain no surprises. Once you have engaged an auditor, you must plan for the entrance conference. Ensure that adequate and knowledgeable staff is available, that adequate time is scheduled without interruption, and that a congenial atmosphere is maintained. Be familiar with the areas to be audited and know the procedures used to test those areas.

You must communicate audit requirements with your POCs and employees to ensure a smooth audit process. Knowledgeable personnel must be available to the auditor throughout the audit. By having a proper escort, the auditor's questions are likely to be answered correctly, and there is less likelihood of delays in the conduct of the audit.

Information obtained in the audit process should be monitored, appropriately catalogued, and filed for immediate or later action.

Now let's look at required reporting.



Reporting



Reporting is required according to the OMB Circular A-123, Management's Responsibility for Internal Control. Recent government-wide initiatives have been implemented to:

- **improve program and financial management**
- **accelerate reporting**
- **assess the effectiveness and efficiency of program operations.**

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Preparing for an Audit

L3-59

We have just discussed the reporting requirements for the audit of financial statements, now let's discuss management reporting required by OMB Circular A-123, Management's Responsibility for Internal Control.

Internal control includes the plan of organization, methods, and procedures adopted by management to meet its goals. It includes processes for planning, organizing, directing, controlling, and reporting on agency operations. Recent government-wide initiatives have been implemented to improve program and financial management, including tracking corrective actions for material weaknesses, imposing accelerated reporting due dates for more timely financial information, and assessing the effectiveness and efficiency of program operations.

Reporting provisions within these initiatives include the requirements for annual reporting on the control and financial systems required by Sections 2 and 4 of the FMFIA, annual reports on actual performance compared to goals required by the Government Performance and Results Act (GPRA), annual auditors' reports on internal control and compliance with laws and regulations related to financial reporting, semiannual reports by the DoDIG to Congress on significant abuses and deficiencies identified during reviews required by the IG Act, annual reports on the effectiveness of the agencies' security programs required by the Federal Information Security Management Act of 2002 (FISMA), annual estimates of improper payments required by the Improper Payments Information Act of 2002, and the annual report on the progress toward achieving goals for improving the efficiency and effectiveness of agency operations required by the Clinger-Cohen Act of 1996.

OMB Circular A-123, Management's Responsibility for Internal Control, consolidates many of these reporting requirements.



Reporting (cont.)



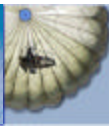
Required Reports:

- **Statement of Assurance**
- **Statement of Assurance for Internal Control over Financial Reporting**
- **Statement on Conformance to Financial Systems Requirements**

According to OMB Circular A-123, management must annually provide assurances on internal control in its Performance and Accountability Report, including a separate assurance on internal control over financial reporting, along with a report on identified material weaknesses and corrective actions.

The assurance statements and information related to Section 2, Section 4, and internal control over financial reporting are provided in a single FMFIA report section of the annual PAR labeled Management Assurances. This section includes the annual assurance statements, summary of material weaknesses and non-conformances, and summary of corrective action plans. Management's assurance statement relating to internal control over financial reporting and any related material weaknesses and corrective actions is separately identified.

Let's examine these reports.



Reporting (cont.)



Statement of Assurance:

- **Unqualified statement of assurance**
 - No material weaknesses reported
- **Qualified statement of assurance**
 - Considers exceptions explicitly noted
 - One or more material weaknesses reported
- **Statement of no assurance**
 - No processes in place or pervasive material weaknesses

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Preparing for an Audit

L3-61

Pursuant to Section 2 of the FMFIA, the head of each executive agency submits to the President and the Congress a statement on whether there is reasonable assurance that the agency's controls are achieving their intended objectives, and a report on material weaknesses in the agency's controls.

The statement of assurance represents the agency head's informed judgment as to the overall adequacy and effectiveness of internal control within the agency. It must take one of three forms:

- unqualified statement of assurance (no material weaknesses reported)
- qualified statement of assurance, considering the exceptions explicitly noted (one or more material weaknesses reported)
- statement of no assurance (no process in place or pervasive material weaknesses).

Sources used in making this determination include management reviews, IG reports, program evaluations, audits of financial statements, reviews of financial systems, FISMA reports, performance plans and reports pursuant to GPRA, and results from tests of key controls performed as part of the assessment of internal control over financial reporting. The agency head describes the analytical basis for the type of assurance being provided and the extent to which agency activities were assessed.

Consideration is taken in the use of source information to determine whether the processes used by the source included an evaluation of internal control. Managers coordinate their efforts with other evaluations to the extent possible to avoid duplication. Once the type of assurance is determined, the agency head signs the statement.

Let's look at the next report.



Reporting (cont.)



Statement of Assurance for Internal Control over Financial Reporting:

- **A statement of management's responsibility for the establishment of internal controls**
- **A statement identifying the OMB Circular A-123, as the framework used to conduct the assessment**
- **An assessment of the effectiveness of the agency's internal control over financial reporting as of June 30**

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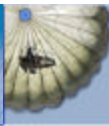
Preparing for an Audit

L3-62

Management is required to include an assurance statement on the internal controls over financial reporting in its annual PAR. This statement is management's assessment of the effectiveness of the agency's internal control over financial reporting as of June 30 of that fiscal year. This assurance statement is required to include:

- A statement of management's responsibility for establishing and maintaining adequate internal control over financial reporting for the agency
- A statement identifying the OMB Circular A-123, as the framework used to conduct the assessment of the effectiveness of the agency's internal control over financial reporting
- An assessment of the effectiveness of the agency's internal control over financial reporting as of June 30, including explicit conclusion as to whether the internal controls are effective

Let's continue this discussion.



Reporting (cont.)



Statement of Assurance for Internal Control over Financial Reporting (cont.):

- **If a material weakness is discovered by June 30, but corrected by September 30, a statement identifying the material weakness, the corrective action taken, and that it has been resolved by September 30 is required.**
- **If a material weakness is discovered after June 30, but prior to September 30, the statement identifying the material weaknesses should be updated to include the subsequently identified material weakness.**

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Preparing for an Audit

L3-63

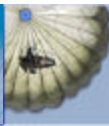
Continuing with the discussion of the Statement of Assurance for Internal Control over Financial Reporting:

- If a material weakness is discovered by June 30, but corrected by September 30, a statement identifying the material weakness, the corrective action taken, and that it has been resolved by September 30 is required.
- If a material weakness is discovered after June 30, but prior to September 30, the statement identifying the material weaknesses should be updated to include the subsequently identified material weakness.

This statement is reported in the same three forms as the previously discussed Statement of Assurance: unqualified, qualified, and statement of no assurance.

A separate audit opinion on internal control over financial reporting is not required if an agency receives an audit opinion on internal control over financial reporting. Agencies electing to receive this opinion may adjust the “as of” reporting date of June 30 to coincide with the “as of” date of the audit opinion.

Now let's discuss the final report.



Reporting (cont.)



Statement on Conformance to Financial Systems Requirements:

If the agency's systems do not substantially conform to financial systems requirements, the statement must list the nonconformances and discuss the agency's plans for bringing the systems into substantial compliance.

Section 4 of the FMFIA requires an annual statement on whether the agency's financial management systems conform to government-wide requirements. These requirements are mandated by the FMFIA and OMB Circular A-127, Financial Management Systems. If the agency's systems do not substantially conform to financial systems requirements, the statement must list the nonconformances and discuss the agency's plans for bringing the systems into substantial compliance. Financial management systems include both financial and financially related (or mixed) systems. Section 7 of OMB Circular A-127 provides guidance on systems requirements.

Let's discuss some ways in which you can help in this process.



Reporting (cont.)



Best Practices for Reporting:

- **Report information consistently**
 - In accordance with OMB Circular A-123, Management's Responsibility for Internal Control
 - In accordance with OMB Circular A-127, Financial Management Systems
- **Make reporting an ongoing process, not just annually.**
- **Continuously monitor and improve internal controls.**
- **Keep databases up to date and accurate.**
- **Map your reports flow.**

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Preparing for an Audit

L3-65

To ensure that applicable information is available on whether the agency's controls are achieving their intended objectives, on material weaknesses in the agency's controls, and on whether the agency's financial management systems conform with government-wide requirements, you must report information consistently in accordance with OMB Circular A-123, Management's Responsibility for Internal Control which incorporates Section 2 of the FMFIA, and OMB Circular A-127, Financial Management Systems, which incorporates Section 4 of the FMFIA.

This requires that you make financial management an ongoing process, not just annually. Agency managers who continuously monitor and improve the effectiveness of internal control associated with their programs have established the foundation that provides the basis for the agency head's annual assessment of and report on internal control.

By keeping databases up to date and accurate, you may reduce data entry and input errors.

Mapping your reports flow allows you to anticipate requirements for internal control reporting.

Let's summarize what we learned in this lesson.



Lesson Summary

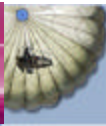


- **Roles and Responsibilities**
- **Discovery and Correction**
- **Validation**
- **Assertion**

In this lesson, you learned that auditors perform assessments and that auditee teams are responsible for the overall presentation of information to the auditors. This information is the responsibility of the entity management. DoD entities are responsible for improvement plans designed to ensure that the Department achieves an unqualified audit opinion on DoD-wide financial statements. DFAS continually reviews current finance and accounting systems and procedures to identify improvements that can be made to processes and systems.

In looking at the five-phase process used by the DoD leadership to prepare for a clean audit, you found that the Discovery and Correction Phase is intended to correct deficiencies and plan solutions to produce accurate data. The Validation Phase purpose is to validate the effectiveness of the corrective actions, and to determine if sufficient controls, transaction information, and supporting documentation are available to support management's assertion that the line or statement is ready for audit. In the Assertion Phase, entity management notifies the DoDIG that validation of corrected deficiencies has been completed and that a financial statement or line item is ready for audit.

Let's continue.



Lesson Summary (cont.)

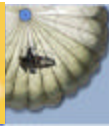


- **Assessment**
- **Audit**
- **Reporting**

In the Assessment Phase, the DoDIG assess the reliability of the line or statement which the entity asserted as being ready for audit. That assessment is generally done first if a statement has never been audited. In the Audit Phase an auditor obtains an opinion of the condition of an entity's financial statement or line, or on the fairness of the presentation of the information in the financial statements. You found that the DoDIG determines the appropriate scope and nature for financial audit and the associated reports.

In discussing reporting, you learned that annually, management must provide assurances on internal control in its PAR, including a separate assurance on internal control over financial reporting, along with a report on identified material weaknesses and corrective actions.

The following slides list references available for additional information.



References



FFMIA: <http://www.ignet.gov/pande/faec/gaoffmia.pdf>

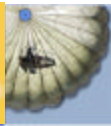
FMFIA:

<http://www.whitehouse.gov/omb/financial/print/fmfia1982.html>

Inspector General Act:

<http://www.uscode.house.gov/uscode-cgi/fastweb.exe>

CFO Act: <http://www.oirm.nih.gov/itmra/cfoact.html>



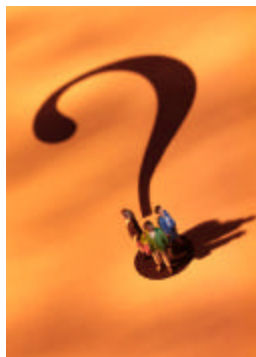
References

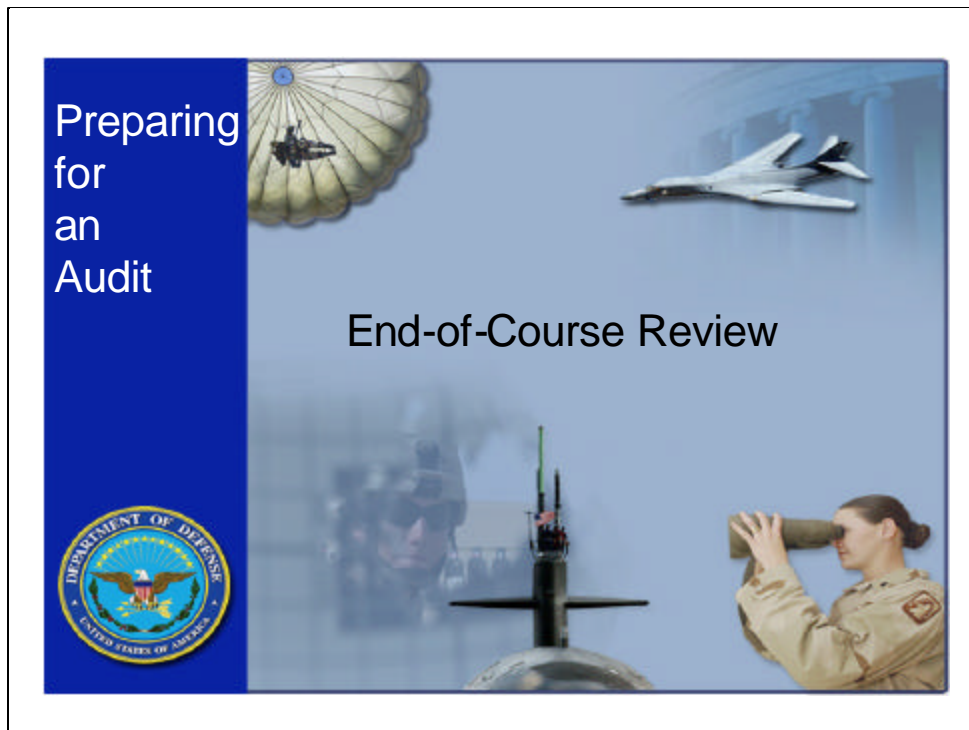


GAO: <http://www.gao.gov>

OMB Circular No. A-123:

<http://www.whitehouse.gov/omb/circulars/a123/text/a123.html>





Let's review the course objectives that we discussed today in this course.

You should now be able to describe the value of financial statement audits and why we do them, describe how the auditable data links into the DoD Financial Statements, and describe how to prepare to assert your readiness for an audit.

Let's review why we audit, auditable data and audit methodology, and the steps for a clean audit.



End-of-Course Review



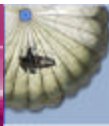
Lesson 1, Why Audit?:

- **Types, purpose, and value of audits**
- **Common auditing terminology**

Lesson 1, Why Audit?; explained why audits are required and necessary. It described the history for the requirement to report on the use of resources; the legal and regulatory guidance that requires the application of accounting standards, reporting, control, and accountability; and the goals of the Department in obtaining an unqualified or clean audit opinion. This lesson defined common auditing terms and identified various government auditing entities and the applicable hierarchy and guidance used for audits of the financial statements.

In this lesson, you learned that financial statement audits report on whether or not an entity's financial reports fairly reflect the true financial position of that entity as of a particular point in time. You found that we audit because it's the responsibility of the government to its citizens to ensure that trust, and because better and more reliable information means better decisions by the Department's leadership at all levels.

In discussing common auditing terminology, you found that an unqualified opinion is the most preferred finding. An unqualified opinion has no material exception to the reliability of the items specified on the financial statements within the limits of the audit.



End-of-Course Review



Lesson 1, Why Audit? (cont.):

- **Legal and regulatory requirements**
- **Financial Statements**
- **Auditing entities**
- **Applicable guidance**

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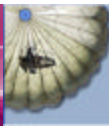
Preparing for an Audit

R-3

We then discussed legislation such as the Federal Financial Manager's Improvement Act, the Federal Manager's Financial Integrity Act, the Inspector General Act, and the Chief Financial Officers Act, and regulatory requirements contained in OMB Circulars and Bulletins, the Treasury Financial Manual, and the DoDFMR. We discussed how these requirements provide for the preparation and audit of entity financial statements and operations.

You learned that there are several federal government auditing entities, including the GAO, the DoDIG, and other audit agencies. The FASAB, governs what constitutes accounting standards for U.S. government reporting entities, and the first category is FASAB Statements and Interpretations, and AICPA and FASB pronouncements made applicable to federal government entities. For every requirement at the highest level of authority in an organization, there is an agency-specific requirement that interprets, assigns responsibility, or provides instruction to succeeding levels of the organization.

Now let's review Lesson 2, Auditable Data and Audit Methodology.



End-of-Course Review



Lesson 2, Auditable Data and Audit Methodology:

- **Feeder and accounting systems**
- **Effect of intragovernmental transactions**
- **Sources of input**
- **Day-to-day operations**
- **Financial Audit Manual (FAM)**

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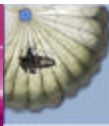
R-4

Lesson 2 explained how the various feeder systems affect the financial statements. You learned that feeder systems provide specific data to the general ledger, and that data is only as good as the feeder system that collects the specific information. These systems, both manual and automated, must be audited to be certain that there are no material mis-statements of information to the general ledger.

We described the effect of intragovernmental transactions on the financial statements. We then described sources of input to the financial statements through various feeder and financial management systems.

Day-to-day operations are your opportunity to build lines of communication and establish clean audit trails. Having a documented audit trail to substantiate transactions on a daily basis will make the transition into an audit successful.

The FAM checklist was also reviewed to see what the auditors may look for.



End-of-Course Review



Lesson 2, Auditable Data and Audit Methodology (cont.):

- **Government Accountability Office (GAO)**
- **Planning**
- **Internal controls**
- **Testing**
- **Communications**

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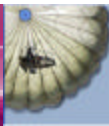
R-5

The lesson defined a federal government audit and the methodology used to initiate and conduct it. GAO provides guidance on a variety of subjects to include Government Auditing Standards, more commonly called the Yellow Book. We discussed these standards for audits of government organizations, programs, activities, and functions.

We then discussed the audit methodology represented by planning, internal control, and testing. In planning we found that the audit team determines what evidential matter is needed to achieve the audit objectives. In the Internal Controls Phase of the audit, auditors examine the internal controls of your organization to determine whether they are effective. This examination is used to determine the nature, timing, and extent of tests to be conducted in the Testing Phase of the audit.

There is no substitute for quality communications. Both internal and external communications play a role in the continued financial strength and viability of all entities in the DoD.

Now let's review Lesson 3, Steps for a Clean Audit.



End-of-Course Review



Lesson 3, Steps for a Clean Audit:

- **Roles and Responsibilities**
- **Discovery and Correction**
- **Validation**
- **Assertion**

Lesson 3, Steps for a Clean Audit, explained that reaching the goal of receiving an unqualified opinion on the DoD-wide financial statements in FY2007 requires that we do not waste our efforts on audits of unreliable information. Rather, we should focus our efforts (and funding) on preparing entities within the DoD to pass an audit. It then explained the steps to prepare for an audit.

In this lesson, you learned the roles and responsibilities of various individuals and entities. Auditors assess the information presented, and this information is the responsibility of the entity's management. You also found that improvement plans are designed to ensure that the Department achieves an unqualified audit opinion on DoD-wide financial statements, and are the responsibility of the services. DFAS examines finance and accounting processes and systems to identify improvements that can be made to them.

The Discovery and Correction Phase is intended to correct deficiencies and plan solutions to produce accurate data. The Validation Phase determines if sufficient controls and transaction information are available to support management's assertion that the line or statement is ready for a audit. The Assertion Phase is used to notify the DoDIG that validation of corrected deficiencies has been completed.



End-of-Course Review



Lesson 3, Steps for a Clean Audit (cont.):

- **Assessment**
- **Audit**
- **Reporting**

The Assessment Phase assesses the reliability of the line or statement that the entity asserted as being ready for audit. The assessment is generally to be done first if a statement has never been audited. During the Audit Phase, an auditor substantiates an opinion of the fairness and presentation of the information in the financial statements. The DoDIG determines the appropriate scope and nature of financial statements audits and reports.

In discussing reporting, you learned that the head of each executive agency submits reports on the agency's controls, weaknesses, and financial management systems annually.

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Appendix A. Glossary

This glossary should serve as a reference tool for DoD personnel who need an understanding of auditing terminology. It is not all-inclusive and reflects both acronyms and terms introduced throughout this course.

Acquisition	To come into possession or control, by purchase or other means, of a new or improved asset.
AcSEC	Accounting Standards Executive Committee (of the AICPA)
ADP	Automated Data Processing is the use of computer equipment to facilitate accounting, budgeting, and other processes.
AICPA	American Institute of Certified Public Accountants
AIMD	Accounting and Information Management (GAO)
Allocation Assertion	See valuation
Amortization	The periodic recognition of the consumption (expense) of an intangible asset
AR	Army Regulation
Assertion	Explicit and implicit information provided by management that attests to the represented financial position or results of operations
Assertion Letter	A representation by management that a financial statement or line item is ready for audit
Asset	The property owned by an entity. Assets are classified in several ways, including assets that are tangible and intangible. While tangible assets are more easily defined, intangible assets are those long-lived assets useful in the operation of entity that are not held for sale and have no physical qualities. Examples of intangible assets include patents, copyrights, franchises, trademarks, trade names, and goodwill.
AT&L	Acquisition, Technology, and Logistics is an office located within the Office of the Secretary of Defense.
Auditable	The condition where underlying data and procedures are sufficient, accurate, testable, and reliable enough for an auditor to obtain a basis for forming an unqualified opinion
Audit Ready	The condition where underlying data is auditable and the staff is ready to support that data in an audit process

Audit Risk	A risk is taken when an auditor unknowingly fails to modify his or her opinion appropriately on financial statements that are materially misstated
Audit Trail	A chain of evidence provided by coding, cross references, and documentation connecting account balances and other summary results with original transaction data
BEA	Business Enterprise Architecture is a mechanism to better manage the Department's business operations and to structure the complex systems and organizational interrelationships.
Benchmark	A standard against which others are measured
Best Practice	A process or procedure that can be used as a good example for others in similar organizations
BMMP	The Business Management Modernization Program is a vehicle designed to transform business operations and improve oversight and accountability for the billions of dollars spent designing, building, operating, and maintaining business systems that support the Department's primary missions.
BRAC	The Congressional mandate to eliminate excess physical capacity, the operation, sustainment, and recapitalization of that which diverts scarce resources from Defense capability
Capitalize	To record and carry forward into one or more future periods any expenditure from which the benefits will then be realized
CFE	Chief Financial Executive
CFO	A Chief Financial Officer is an organization's senior financial executive.
CFOA	The Chief Financial Officers Act of 1990 is intended to improve financial management systems and information to produce timely, reliable, and comprehensive financial information.
CFOC	The Chief Financial Officers Council is an organization of the CFOs and Deputy CFOs of the largest federal agencies, senior officials of the Office of Management and Budget, and the Department of the Treasury, who work collaboratively to improve financial management in the U.S. government.
CIP	Construction in Progress
Completeness Assertion	An assertion about whether all transactions and accounts that should be presented in the financial statements are so included

Compliance	The conformity to the rule of law, standard practice, or specified procedure
COTS	Commercial Off-the-Shelf
CPE	Continuing Professional Education
Cycle Memorandum	A depiction in words and/or a diagram form of the activities relating to a particular type of transaction such as the revenue cycle, expenditure cycle, financing cycle, personnel services cycle, or production cycle
DCAA	The Defense Contract Audit Agency is responsible for performing all contract audits for the Department, and providing accounting and financial advisory services regarding contracts and subcontracts to all DoD components responsible for procurement and contract administration.
D.C.	District of Columbia
DD	Department of Defense (Form)
DDRS	Defense Department Reporting System
DeCA	The Defense Commissary Agency intends to deliver the premier quality of life benefit to the armed services community to enhance recruiting, retention and readiness by efficiently and effectively providing exceptional savings and excellent products and services – every time, every place.
Depreciation	The allocation of the cost of an asset over a period of time for accounting and/or tax purposes. Also, a decline in the value of property due to general wear and tear or obsolescence
DFAR	Defense Federal Acquisition Regulation
DFAS	The Defense Finance and Accounting Service has the mission to provide responsive, professional finance and accounting services for the people who defend America.
Deficiency	In an audit, the term deficiency describes a lack in adequate competence, readiness, knowledge, or means. It may be synonymous with fault.
DISA	Defense Information Systems Agency
Disclosure	Making something known to the public, as in disclosing the financial position of an entity through the publishing of its financial statements and accompanying notes

DLA	The Defense Logistics Agency provides worldwide logistics support for the missions of the military departments and the Unified Combatant Commands under conditions of peace and war. It also provides logistics support to other DoD components and certain federal agencies, foreign governments, international organizations, and others as authorized.
DMPO	Defense Military Pay Office
DoD	Department of Defense (also referred to as the Department)
DoDFMR	Department of Defense Financial Management Regulation (7000.14-R)
DoDIG	Department of Defense Inspector General
DPAS	Defense Property Accountability System
DWCF	Defense Working Capital Fund
EDA	Electronic Document Access
ENG	Engineer
Engagement	Describes the process of conducting an audit. It is the formal agreement to provide a service, as in an audit engagement letter or contract
Entity	An organization, unit, or body, such as a department, fund, agency, or section
ESC	Executive Steering Committee
Evidential Matter	Audit evidence that consists of underlying accounting data or financial records and all corroborating information available to an auditor
Existence Assertion	An assertion about whether assets or liabilities of an entity exist at a given date, and whether recorded transactions have occurred during a given period. This is also called existence occurrence.
Existence Occurrence	See existence assertion.
FAM	The Financial Audit Manual is a manual established by the GAO and the PCIE to ensure that the financial statement audits have their intended outcome.
FAR	Federal Acquisition Regulation

FASAB	The Federal Accounting Standards Advisory Board has the mission to promulgate federal accounting standards after considering the financial and budgetary information needs of citizens, congressional oversight groups, executive agencies, and the needs of other users of federal financial information.
FASB	Financial Accounting Standards Board
FFMIA	The Federal Financial Management Improvement Act builds on the CFO Act by emphasizing the need for agencies to have systems that can generate timely, accurate, and useful information with which to make informed decisions and to ensure accountability on an ongoing basis.
FII	The Financial Improvement Initiative promotes the achievement of an unqualified opinion on the Department's consolidated financial statements by FY07.
FISCAM	Federal Information System Controls Audit Manual
FISMA	Financial Information Security Management Act of 2002
FMFIA	The Federal Manager's Financial Integrity Act requires federal managers to establish a continuous process for evaluating, improving, and reporting on the internal control and accounting systems for which they are responsible. It further requires that, each year, the head of each executive agency subject to the Act shall submit a report to the President and Congress on the status of management controls and financial systems that protect the integrity of agency programs and administrative activities.
FMMP	The Financial Management Modernization Program was renamed the BMMP on May 20, 2003.
FMR	Financial Management Regulation (see DoDFMR)
FMS	The Foreign Military Sales program manages government-to-government purchases of weapons and other defense articles, defense services, and military training.
FUDS	Formally Used Defense Sites is a type or classification of site, comparable to DoD installation or BRAC site.
FY	Fiscal Year
GAAP	General accepted accounting principles is the common set of accounting principles, standards, and procedures. GAAP is a combination of authoritative standards (set by policy boards) and the accepted ways of doing accounting.

GAAS	Generally Accepted Auditing Standards
GAGAS	Generally Accepted Government Auditing Standards
GAO	The Government Accountability Office, previously called the General Accounting Office, is an independent, nonpartisan agency that works for Congress. The GAO is often called the “congressional watchdog” because it investigates how the federal government spends taxpayers’ dollars.
GLAC	General Ledger Account Codes
GMRA	The Government Management Reform Act of 1994 updated the CFOA by setting standards for the effectiveness of financial management reporting.
GPRA	The Government Performance and Results Act of 1993, aims to improve federal program effectiveness and public accountability by promoting a new focus on results, service quality, and customer satisfaction.
GRS	The General Records Schedule is issued by the Archivist of the United States to provide disposition authorization for records common to several or all agencies of the federal government.
GS	General Schedule
GSA	General Services Agency
IAW	In accordance with
IBM	International Business Machines
ID	Identification
IG	The Inspector General has traditionally served as “an extension of the eyes, ears, and conscience of the Commander.” Pursuant to the Inspector General Act of 1978, as amended, “the Inspector General of the Department of Defense shall . . . be the principal adviser to the Secretary of Defense for matters relating to the prevention of fraud, waste, and abuse in the programs and operations of the Department.”
IGT	Intergovernmental Transaction
IMPAC	International Merchant Purchase Authorization Card
IPA	Independent Public Accountant

Internal Controls	Refers to processes that are designed to provide reasonable assurance regarding the achievement of objectives in the reliability of financial reporting, compliance with applicable laws and regulations, and the effectiveness and efficiency of operations
Internal Review	An inspection of processes and data of an entity by personnel employed by or internal to the entity
JFMIP	The Joint Financial Management Improvement Program is a joint and cooperative undertaking of the Department of the Treasury, the GAO, the OMB, and the OPM working in cooperation with each other and other agencies to improve financial management practices in government.
LAC	Latest Acquisition Cost
Liability	A legal responsibility or accountability for an amount owed
MAC	Moving Average Cost
Materiality	In an audit, materiality refers to the degree of importance or consequence.
MC	Management Control (see also MCP)
MCP	A management control program provides reasonable assurance that obligations and costs comply with applicable laws and emphasizes prevention of waste, fraud, mismanagement, and timely corrections of MC weaknesses.
MDA	The Management Discussion and Analysis section, found on financial statements, allows management to discuss aspects of an entity's financial statement that may be otherwise difficult to locate. It provides a summary and more.
MIPR	Military Interdepartmental Purchase Request
N/A	Not available
NARA	The National Archives and Records Administration ensures for the citizens and the public servant, for the President, Congress, and Courts, ready access to essential evidence.
NASBA	National Association of State Boards of Accountancy
NDPP&E	The National Defense PP&E was previously expensed in the period incurred, but all are now classified as general PP&E and capitalized, with the exception of the cost of land and land improvements that produce permanent benefits, which are depreciated.

No.	Number
Non-statistical Sampling	A group of methods used in audits to determine the size of a sample to be tested and the evaluation of the results that is less objective and more subjective and judgmental than the statistical sampling approach
NRV	Net Realizable Value is a valuation method.
O&M	Operations and Maintenance
OFFM	The Office of Federal Financial Management was created within the OMB by the CFOA of 1990. The OFFM is responsible for the financial management policy of the federal government including implementing the financial management improvement priorities of the President, establishing government-wide financial management policies of executive agencies, and carrying out the financial management functions of the CFOA.
OIG	Office of Inspector General
OMB	The Office of Management and Budget has a mission to assist the President in overseeing the preparation of the federal budget and to supervise its administration in Executive Branch agencies.
OM&S	Operating Material and Supplies
OPM	The Office of Personnel Management is the federal government's human resource agency.
OUSD(C)	Office of the Under Secretary of Defense (Comptroller)
OUSD(HA)	Office of the Under Secretary of Defense (Health Affairs)
P&EP	Property and Equipment Policy
PAD	Process Analysis Documents
PARS	Performance and Accountability Reports
PBC	A Prepared by Client list is a list that facilitates the audit process by coordination with specific points-of-contact.
PCIE	The President's Council on Integrity and Efficiency was established to address integrity, economy, and effectiveness issues that transcend individual government agencies, and increase the professionalism and effectiveness of IG personnel throughout the government.
P&EP	Property and Equipment Policies

PMA	The President's Management Agenda is an aggressive strategy for improving the management of the federal government. It focuses on five areas of management weaknesses across the government where improvements and the most progress can be made.
PMO	Program Management Office
POC	Point of Contact
Population	In an audit, a population is a class of transactions or the account balance to be tested.
PP&E	Property, Plant, and Equipment
Qualified Opinion	An auditor's opinion stating that except for the effects of the matter(s) to which the qualification relates, the financial statements present the position of the organization fairly.
Readiness	See audit ready.
Reasonable Assurance	Assurance that a reasonable person can reach the same conclusion given the same data and circumstances. Not an absolute certainty.
RFA	Ready for Audit
Rights and Obligations Assertion	An assertion about whether assets are the rights of the entity, and liabilities are the obligations for the entity, at a given date
Risk Adverse	A condition in which an auditor is not willing to accept a moderate or high level of audit risk, usually when the client has a greater likelihood of financial failure or there are many users of the statements and audit reports
RPC	Review and Prioritization Committee
RPS	Review and Prioritization Sub-committee
Sample	In an audit, a sample is a single unit within a class of transactions or account balances to be tested.
SAS	Statements of Accounting Standards
SEC	Securities and Exchange Commission
SECDEF	Secretary of Defense
SFFAC	Statement of Federal Financial Accounting Concepts

SFFAS	Statement of Federal Financial Accounting Standards is the standards issued by the FASAB to implement the GAAP for the federal government.
SGL	Standard General Ledger
SOA	Statement of Accountability
SOP	Standard Operating Procedure
Source Documentation	Documents representing authorization for original transactions and associated with transaction data. These documents include contracts, invoices, funding authorizations, bills of lading, receiving reports, titles, mortgages or notes, leases, agreements, appointments, signature cards, policies, and others.
Statistical Sampling	A mathematical method or combination of methods used to determine the number of items in a population to examine
Systemic	Describes a problem involving one or more financial reporting systems that results in an inability to provide accurate, reliable, or timely financial data
TDY	Temporary Duty
TFM	Treasury Financial Manual
TI	Treasury Index is the Treasury's code for the various funds used in the federal government. Examples in DoD include TI 97, 57, 21, and 17.
TPA	Trading Partner Agreement
Unqualified Opinion	An auditor's opinion that is without any material exception as to a general statement of reliability of the items specified within the limits of an audit
U.S.	United States
USD	Under Secretary of Defense
USD(C)	Under Secretary of Defense, Comptroller
USSGL	United States Standard General Ledger provides a uniform Chart of Accounts and technical guidance to be used in standardizing federal agency accounting.
USTRANSCOM	The United States Transportation Command is a unified command composed of elements from each of the services to provide air, land, and sea transportation for the DoD.

Validation	The corroboration, substantiation, or confirmation of relevant or meaningful information, supported by objective truth or generally accepted authority
WCF	The Working Capital Fund was established to be self-sustaining where products or services are produced and sold to recover the full cost of operations.

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Appendix B. Assertion Package Organization and Review Criteria

The following is provided as a reference obtained from Attachment 4 of the USD (C) Memorandum, Subject: Financial Improvement Initiative Business Rules, dated June 23, 2004.

TAB	TOPIC	CHECKLIST STEP
1	Process Cycle Memos and Flow Charts	1
2	GL Transaction Detail/Support	2
3	Evidential Matter	3
4	Validation Summary (Management Assertion Letter, Completed Assertion Checklist, and Validation Work Products such as completed GAO Checklists, etc)	4
5	Status of FIP Corrective Actions	5
6	Summary of Corrective Actions Taken	6
7	Organization Charts/Contact Lists	7
8	FISCAM and SAS 70/88 Audit Date(s) and POCs	8
9	FISCAM and SAS 70/88 Audit Results	9
10	Hardware, Software, and Interfaces	10
11	Type of Data Produced	11
12	Telecom/Network Information	12
13	Certifications/Accreditations	13
14	System/End User Locations	14
15	Location of Systems Documentation	15
16	Data Type/Summary of Transactions (Number, Type, Dollar Value)	16
17	List of Authorized Users	17
18	List of On-Going or Planned Reviews	18

v	Step	Description	Assertion Package Tab	Evaluation Criteria
	1	Identify and document the procedures, processes, and control points for deriving the balance(s) being asserted. Include the systems that are used and the flow of data from field level to departmental level. This can be done in a cycle memorandum or flow chart format. Having this information prepared in advance will be a great tool for you to refer to during the assessment and audit. Also, the auditors will need to document the information so you will already have the information prepared. Be sure to identify all systems that have detail that make up the balance(s) being asserted as ready for audit.	Place cycle/process memorandum, flow documents, questionnaires, directives, and procedures at TAB 1 of the assertion package.	<p>A flowchart(s) is required for each major process and a cycle/process memorandum (a description of a cycle memorandum is in the GAO Financial Audit Manual Section 390.04, “Cycle Memorandum and Flowchart”) should be provided to:</p> <ul style="list-style-type: none"> • accurately describe the regulations followed for the process, • document procedures utilized, • document key control techniques, • identify systems used at the departmental level, and • include the management control objectives and risk assessments. <p>Review the flowchart(s), cycle/process memorandum, and supporting documents for reasonableness and completeness for each process listed.</p>

v	Step	Description	Assertion Package Tab	Evaluation Criteria
	2	Have all General Ledger transaction detail and supporting information from feeder systems available for all other transactions that make up the balance(s) being asserted. Ensure the total of the detail equals the balance of the line item. This includes all accounting adjustments that have an effect on the ending balance of a line item reported on the financial statements.	Place supporting GL transaction detail information at TAB 2 of the assertion package.	Review the provided detailed description/flow chart of the reconciliation process performed. The detailed description should describe how the line item balance is fully supported by the General Ledger, the General Ledger is fully supported by the Subsidiary Ledgers, and each transaction in the Subsidiary Ledgers is supported by the appropriate supporting evidential matter. The description should demonstrate that the data is readily available and should provide POCs for the data.
	3	Consolidate evidential matter that supports the transactions in step 2 or map where the evidential matter is located for easy and expedient retrieval.	Where practical, include Evidential Matter at TAB 3 , if space does not permit, include detailed information of where the evidential matter is located.	Review the description of the supporting evidential matter (i.e. contracts, invoices, receiving reports, etc.) for reasonableness and completeness. Verify that the location of the supporting evidential matter is identified.
	4	Prepare a summary of validation work performed by management Service auditors, Internal auditors, or independent public accounting firms to establish audit readiness, as applicable.	Place Validation Summary, the Management Assertion Letter, the completed assertion package checklist, and validation work products in TAB 4 .	Verify the presence of the Management Assertion Letter. Verify Validation Summary is present, describes validation methodology, and appears reasonably complete and accurate. Verify the separation of duties between the persons generating the assertion packages and the persons validating the assertion packages. If separation of duties does not exist, review the adequacy of management's explanation of why it deemed separation of duties was not needed.

v	Step	Description	Assertion Package Tab	Evaluation Criteria
	5	Complete all the corrective actions in your Mid-Range Financial Improvement Plan (FIP) for the material deficiencies related to the balance(s) being asserted.	Place a statement in TAB 5 that all corrective actions in the FIP related to material deficiencies associated with this line are completed.	Verify that the Management Assertion letter includes a statement that corrective actions identified in the FIP are completed. Also include the comprehensive corrective action plans for identified deficiencies if not part of the FIP.
	6	Using the information from step 5 above, prepare an explanation of the actions taken to fix previously identified or existing problems and incorporate the explanation in the assertion letter or include as attachment to the letter. Be very specific.	Place a status of all FIP corrective actions related to the assertion in TAB 6 .	Verify that the Validation Summary includes: <ul style="list-style-type: none"> • a summary of the corrective actions completed for all known material weaknesses and reportable conditions related to the assertion, OR • a reference to the FIP which documents the completion of all corrective actions related to the assertion.
	7	Compile organization charts indicating key personnel and their responsibilities and phone lists.	Place organization charts at TAB 7 of the assertion package.	Verify that the packages include organization charts for the financial and information technology process owners. The responsible key Government and contractor personnel and their location and contact information should be provided.

v	Step	Description	Assertion Package Tab	Evaluation Criteria
	8	<p>For all the systems identified in step 1 above, has there been a Financial Information Security Audit Manual Controls (FISCAM) or Statement of Auditing Standard (SAS) 70/88 audit conducted on the systems?</p> <ul style="list-style-type: none"> • If yes, provide the date and point of contact and proceed to step 9. • If no, proceed to step 10. 	Place FISCAM / SAS Audit date and POC info at TAB 8 of the assertion package.	Review to verify that the packages include dates and POC info for any FISCAM or SAS 70/88 audit reports on systems identified in step 1.
	9	<p>For the Systems identified in step 1 that you answered Yes in step 8, obtain a copy of the FISCAM or SAS 70/88 audit report and skip the rest of the steps. For the systems identified in step 1 that you answered No in step 8, proceed to step 10. If a FISCAM or SAS 70/88 audit has not been conducted on the system, then the auditors will have to perform alternate procedures on the system. Therefore, the information in steps 10-18 will have to be gathered prior to the audit of each system</p>	Place Audit Report(s) at TAB 9 of the assertion package.	<p>Review to verify that FISCAM or SAS 70/88 audit reports are present for all systems identified in step 1.</p> <p>If no audits were performed go to steps 10-18.</p>

v	Step	Description	Assertion Package Tab	Evaluation Criteria
	10	Prepare a description of the major hardware and software of the system and interfaces with other systems.	Place at TAB 10 of the assertion package.	Verify that for each system identified in step 1, a description of the hardware and software is provided. This description should include interface descriptions. At a minimum, the location of the document containing this information should be provided.
	11	Describe what type of data the system produces for the financial statements, e.g., accounting transactions.	Place at TAB 11 of the assertion package.	Verify that for each system identified in step 1, a description of the type of data the system produces is provided. At a minimum, the location of the document containing this information should be provided.
	12	Prepare a description of telecommunications devices and networks used with the system.	Place at TAB 12 of the assertion package.	Verify that for each system identified in step 1, a description of the telecommunications devices and networks used with the system is provided. At a minimum, the location of the document containing this information should be provided.
	13	Obtain a copy of the most recent certifications and accreditations of the system.	Place at TAB 13 of the assertion package.	Verify that for each system identified in step 1, a copy of the most recent certifications and accreditations of the system is provided. For example, this should include the identification of when the last DoD Information Technology Security Certification and Accreditation Process (DITSCAP) certification and accreditation was performed and include a copy of the most recent Systems Security Authorization Agreement (SSAA). At a minimum, the location of the reports, reviews, certifications and accreditations should be provided.

v	Step	Description	Assertion Package Tab	Evaluation Criteria
	14	Identify the system location(s) and end user locations.	Place at TAB 14 of the assertion package	Verify that for each system identified in step 1, a description of the system location(s) and end user locations is provided. At a minimum, the location of the document containing this information should be provided.
	15	Identify the location(s) of system documentation.	Place at TAB 15 of the assertion package	Verify that for each system identified in step 1, location of system documentation is provided.
	16	Identify the type, dollar value, and number of transactions processed in the system in a month and in a year.	Place at TAB 16 of the assertion package	Verify that for each system identified in step 1, provide a description of the type, dollar value, and number of transactions processed in the system in a month and in a year is provided. In addition, the Component should identify which transactions are material to the assertion. At a minimum, the location of the document containing this information should be provided.
	17	List the type of system users – a type of user would be described as a certain category of employees or an organizations activity with-in an Agency.	Place at TAB 17 of the assertion package	Verify that for each system identified in step 1, system user access information (locations and number of users per location) or a description of the types of users is provided. At a minimum, the location of the document containing this information should be provided.

v	Step	Description	Assertion Package Tab	Evaluation Criteria
	18	Inquire if there are any ongoing or planned system reviews – if there are, determine when the reviews will be complete.	Place at TAB 18 of the assertion package	Verify that for each system identified in step 1, a description any ongoing or planned system review, as well as planned completion dates, is provided. In addition to the system reviews discussed in Steps 8 and 13, also include a copy of the most recent Financial Management Improvement Act (FFMIA) compliance review, DISA readiness reviews, or any other reviews that are ongoing or planned.

Appendix C. Excerpts from the Performance and Accountability Report (PAR)

The following are excerpts from the FY 2004 Performance and Accountability Report.

Message from the Deputy Secretary of Defense

November 15, 2004

I am pleased to present the Department of Defense fiscal year 2004 Performance and Accountability Report.

The Department has made significant progress in transforming America's defense posture to enable decisive plans to address future security challenges. We have demonstrated our superior warfighting capabilities in Iraq and Afghanistan. The price of democracy is not cheap. We see continual pressures on the Department's resources in the years ahead. We will focus relentlessly on efficient and careful use of these resources as we continue fighting the global war on terror.

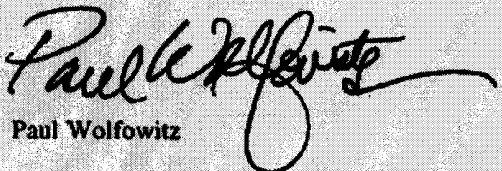
The Department has made improvements in its personnel management practices and we will continue to drive towards a performance-based rating of our workforce. The quality of life of our military members, who risk their lives for all of us to enjoy the freedoms of democracy, has been enhanced by upgrading facilities and advancing private-public partnerships in military housing. We have also seen efficiencies due to practicing performance-based budgeting, increasing our focus on core support functions, and reforming our annual review of programs and funding.

Although the Department received a disclaimer of opinion on its financial statements, there have been advancements throughout the past year in the Department's efforts to improve financial reporting and management processes. Specifically, through the Department's Business Management Modernization Program, the financial management processes and controls are being integrated into the business processes to ensure accountability and auditability of the Department's business transactions.

The Department now has a report card that identifies how well we did in achieving the strategic plan, objectives, and goals. This is an effective management tool that is allowing us to fine-tune our implementation of the strategic plan. Looking at our report card results this year, the Department met several of its performance goals, but still has work to do in other areas. The report displays all of the Department's performance results this year and provides a clear picture of our progress in meeting our objectives.

The Department is committed to effective internal controls, full compliance with established guidelines and standards, and proper stewardship of the resources entrusted to it. During fiscal year 2004, we corrected 11 management control weaknesses, and except for the unresolved weaknesses noted in the Management Discussion and Analysis section of this report, the Department has reasonable assurance that its management controls are effective. The Department will continue its efforts to resolve the remaining issues and I am confident that the Department will continue to fulfill its mission responsibilities.

Looking ahead, the Department continues the transformation of its support structure and management practices. While the Department has made progress in many areas, we must continue to upgrade performance and accountability, streamline and strengthen management, and ensure that every defense dollar is expended as wisely as possible.



Paul Wolfowitz

Report Overview

The Department of Defense fiscal year 2004 Performance and Accountability Report is designed to provide useful information for American citizens, the President, Congress, other federal organizations, and Department of Defense military members, civilians and contractors.

Our report encompasses the Department's operations for fiscal year 2004, which occurred from October 1, 2003, through September 30, 2004. It contains five parts. Combined, they provide a thorough description of the Department's services to the American people and stewardship of our critical resources.

The pressures on the Department's resources have never been greater and will continue to grow in the years ahead. Our response must be to focus relentlessly on efficient and careful use and management of these resources. Only by effectively measuring the results we achieve, as documented in this report, can we adjust the tactics and strategies we use to meet our goal of mission excellence and deliver the best possible performance for the American people.

Part 1: Management Discussion and Analysis is a high-level overview of the Department's performance and financial information for fiscal year 2004. Part 1 starts with a discussion of the Department of Defense (DoD) mission, organization and resources. It highlights the Department's performance—covered in more detail in Part 2—by summarizing the strategic plan and goals and the fiscal year 2004 annual performance goals and results. Next, it provides financial highlights—covered in more detail in Part 3—for fiscal year 2004. The Department's compliance with legal and regulatory requirements is also discussed in this section. Part 1 concludes with a summary of the Department's status on meeting the President's Management Agenda objectives.

Part 2: Performance Information presents the Department's strategic plan, strategic objectives, annual performance goals, and annual performance results for fiscal year 2004 in accordance with the Government Performance and Results Act. It describes key performance indicators—and their fiscal year 2004 goals and results—that the Department uses

to manage risks to the accomplishment of its strategic objectives.

Part 3: Financial Information is composed of the Department's principal financial statements, notes to these statements, consolidating and combining statements, and other required information for fiscal year 2004. This section includes the Inspector General, Department of Defense, Auditors' Report on the fiscal year 2004 financial statements. The Auditors' Report provides the Inspector General's assessment of whether the Department's financial statements are fairly presented in all material respects and conform to generally accepted accounting principles.

Part 4: Inspector General Summary of Management Challenges presents a summary of the most serious management challenges facing the Department. This assessment was prepared by the Inspector General, Department of Defense.

Part 5: Appendixes present detailed information about the Department's compliance with the Improper Payments Information Act of 2002, a glossary of acronyms, and a list of internet links for further information referred to in this report.

We are interested in your feedback regarding the content of this report. Please feel free to email your comments, or requests for copies of this report, to DoDPAR@osd.mil or write to:

U.S. Department of Defense
Office of the Under Secretary of Defense
(Comptroller)
1100 Defense Pentagon
Washington, DC 20301-1100

You may also view this document at www.dod.mil/comptroller/par.



Resources

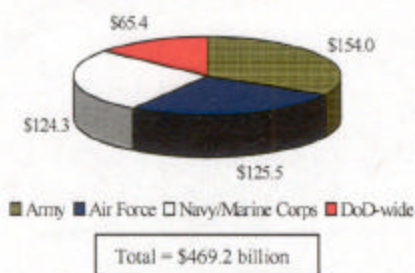
People. To provide the citizens of the United States with the highest level of national security, the Department of Defense employs 1.4 million men and women in the Active Duty, another 1.2 million in the Reserve and National Guard, and approximately 740,000 civilians. Together, these men and women work daily to protect American interests in numerous countries.

Physical Assets. The Department maintains a robust infrastructure, operating approximately 600,000 individual buildings and structures located at more than 6,000 different locations, and using approximately 30 million acres. To protect the security of the United States, the Department uses approximately 250,000 vehicles, 15,000 aircraft, 1,000 oceangoing vessels, and 550 public utility systems.

Budget. The Department's budget for fiscal year 2004 was \$469.2 billion.²

Today, the Department has more than 70 performance metrics in use or under development. The report highlights them in the next two sections, "Performance Highlights" and "Financial Highlights," and they are detailed in Part 2, "Performance Information" and Part 3, "Financial Information."

**Fiscal Year 2004 DoD Budget
(\$ in Billions)**



Because the American people have entrusted these resources to the Department of Defense, the Department is committed to effective resource stewardship and has implemented numerous performance and financial measures to help meet that commitment. The Department continues to research and develop new methods and measures to enhance management and stewardship of these resources.

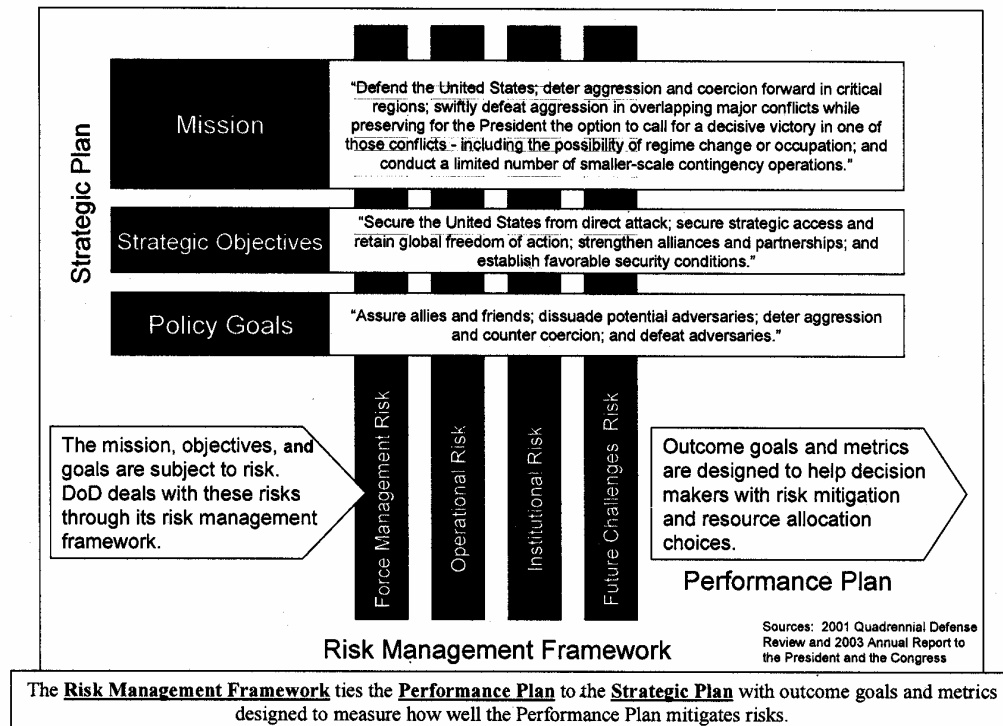
² Does not include Trust Fund or U.S. Army Corps of Engineers Civil Works appropriations.

Annual Performance Goals and Results

Managing risk is a central element of the defense strategy. It involves balancing the demands of the present against preparations for the future consistent with the strategy's priorities. To do this in a consistent, analytic manner, the Department

introduced in 2001 a new risk management framework to help the Secretary and his advisors evaluate tradeoffs among key performance objectives and fundamental resource constraints.

The risk categories are described and illustrated below. Each category has associated outcome goals and metrics designed to gauge performance. This creates a continuous thread to ensure the Department's performance supports the strategy.



1. Force management risk addresses our ability to recruit, retain, train, and equip sufficient numbers of quality personnel and sustain the readiness of the force while accomplishing our many operational tasks.

2. Operational risk focuses on achieving military objectives in a near-term conflict or other contingency.

3. Institutional risk covers the management practices and controls that affect the efficiency with which resources are used and that shape the effectiveness of the Defense establishment.

4. Future challenges risk addresses new capabilities and new operational concepts needed to dissuade or defeat mid-term to long-term military challenges. This risk management framework reflects DoD's experiences over the last decade in attempting to balance strategy, force structure, and resources.

Each of these quadrants is further defined by specific outcome goals. By assessing the Defense establishment in these four areas against those goals, the Department can directly assess how well it is developing and transforming the operational force, realizing key enabling capabilities, and providing the deployment and support infrastructure needed to achieve the strategic goals of the defense strategy.

Financial Highlights

Key Financial information is summarized in this section with detailed financial information provided in Part 3 of this report.

Financial Overview

The Department of Defense continues to improve financial management by overhauling the Department's business and financial management processes and systems. This represents a major management challenge that goes far beyond financial accounting. The Secretary and his senior leaders are committed to changing the Department's business culture, thus improving the Department's combat support infrastructure.

Each year the Department spends billions of dollars designing, building, operating and maintaining business systems that support the troops. Many of these systems support one military service, a specific defense agency, or in some cases, an individual command. Consequently they are unable to operate as a single enterprise network of systems. The Armed Forces of the United States must have business systems that can interact with one another and facilitate the execution of end-to-end business processes; provide DoD decision makers with timely, accurate, and reliable information; comply with all financial management laws, standards, and requirements; and produce auditable financial statements.

Furthermore, the transformation of the business management systems and the business processes they support must be accomplished without interrupting the level of support provided to the warfighter and on-going military operations. This unprecedented, comprehensive, and visionary task remains one of the Department's top priorities.

The Department has already made progress in transforming its business and financial processes and systems.

Nearly 50 percent of the Department's total liabilities received an unqualified audit opinion again this year

As indicated by the table below, six of the Department's subordinate financial statement reporting entities received unqualified audit opinions, one received a qualified audit opinion, and three of the Department-wide financial statement items received favorable audit results. As a result of the Military Retirement Fund receiving an unqualified audit opinion, nearly 50 percent of the Department's total liabilities received unqualified audit opinion again this year.

DoD Component	Audit Opinion
Defense Commissary Agency	Unqualified
Defense Contract Audit Agency	Unqualified
Defense Finance and Accounting Service	Unqualified
Defense Threat Reduction Agency*	Unqualified
Military Retirement Fund	Unqualified
Medicare Eligible Retiree Health Care Fund	Qualified
Inspector General, DoD*	Unqualified
DoD-Wide Financial Statement Lines	Audit Results
Appropriations Received*	Favorable
Federal Employee Contribution Act Liabilities*	Favorable
Investments*	Favorable

* = New for fiscal year 2004

DoD is accomplishing the difficult task of business transformation and improved financial management through the business management modernization program, financial improvement initiative, and financial management balanced scorecard.

Business Management Modernization Program.

During the three years since the Department of Defense began the business management modernization program, significant progress has been achieved in building a baseline architecture, governance structure, and re-engineering methodology to reach the ultimate goal of streamlining and integrating business processes and systems. In 2004, the Department achieved the following.

- Developed specific business transformation metrics that are tied directly to goals, objectives and targets. These metrics represent the program's first set of integrated business transformation metrics.
- Implemented an incremental approach to transformation, which allows DoD to prioritize and focus on the most pressing business transformation initiatives. Although the Department previously had defined Increment 1 (obtaining better financial traceability, total asset accountability, and total personnel visibility), it had not done so for the increments subsequent to it. Increment 2 will focus on reengineering the Department's method of contracting for and acquiring goods and services, accounting for physical assets, and improving military health care delivery. Increment 3 will focus on improving the Programming, Planning, Budgeting and Execution process and achieving an integrated total force picture.
- Established portfolio management policies and broadly outlined duties and responsibilities for managing information technology investments across the department.
- Released version 2.2 of the business enterprise architecture, which includes an enterprise business process model, describing the end-to-end business processes for DoD; it also incorporates statutory, regulatory, and administrative requirements and procedures. Visibility of these requirements in the context of DoD business operations is necessary to correct deficiencies, assure uniform interpretation and implementation, and provide timely, accurate and reliable business information.

The Department will incorporate the remaining statutory, regulatory, and administrative requirements in future versions of the business enterprise architecture. The timetable for these improvements is outlined in the table below.

Release Dates for Future Versions of the Business Enterprise Architecture:

Description	Release Date
Release of Business Enterprise Architecture Version 2.3 <i>Updates all business enterprise architecture work activities, information, system functions and interchanges needed to support the defined enterprise business process model.</i>	November 2004
Release of Business Enterprise Architecture Version 2.4 <i>Continue to detail enterprise business process model. Addresses remaining statutory, regulatory, and administrative requirements and map those deemed financially relevant to the enterprise business process model for increment 1.</i>	January 2005

Through the above accomplishments, DoD has laid the groundwork for significant progress during the coming year. The work is proceeding steadily. The scope and complexity of DoD business processes and systems are too large and unwieldy to change all at once and the transformation will take time. Long term efforts will focus on the following integrated activities.

- Incrementally build and extend a business enterprise architecture,
- Establish and enforce an agency-wide governance process that ensures efficient execution, guidance, and oversight for DoD business transformation and compliance activities,
- Reduce or eliminate redundant, outdated, and stove-piped systems using a systems review and portfolio management process, and

- Reengineer the Department's business processes a piece at a time using an incremental approach.

For detailed information on the Department's Business Management Modernization Program, visit www.dod.mil/comptroller/bmmp/pages/index.html/

Financial Improvement Initiative. Although strategic change through the business management modernization program will take time, the department is taking steps to correct weaknesses and deficiencies using the discipline and methodology of financial audits.

To help meet this objective, the Department launched the financial improvement initiative in 2003. The goal of the financial improvement initiative is to ensure proper transfer of good data and processes into the broader reengineered business processes. By cleansing data and reengineering processes based on the rules documented in the business enterprise architecture, the Department will mitigate the risk of importing poor data and poor controls into the new architecture.

To accomplish the goal of receiving an unqualified audit opinion, the DoD components developed and submitted financial improvement plans listing deficiencies and necessary corrective actions. The financial improvement initiative has allowed the Department to:

- Better define and align financial statement deficiencies to financial statement lines,
- Begin linking deficiencies to enterprise business process model processes, and
- Provide Department-wide oversight and visibility to improving financial statements.

The improvement plans identify deficiencies that must be corrected through policy revisions, process improvements, or systems changes. This information is being linked to the Business Management Modernization Program so that the Department can clearly distinguish between problems that can be solved in the near term through policy and process actions and problems that must be solved through systems changes.

Financial Management Balanced Scorecard. The Department's Financial Management Balanced Scorecard is aligned with the risk management framework established in the Department's strategic plan. The Scorecard provides the framework for

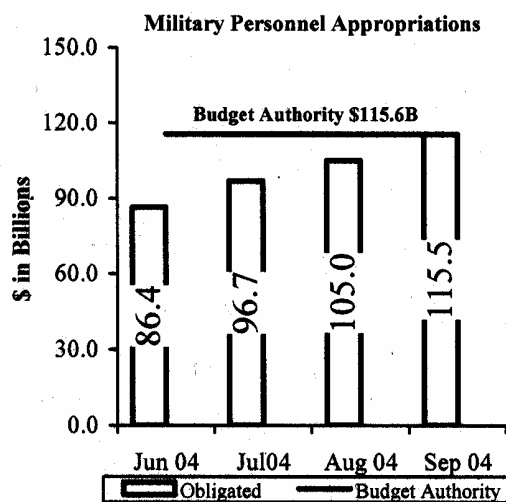
establishing executive-level performance goals and tracking results; designates key performance outcomes, measures, and indicators; and assigns responsibility for cascading performance metrics to the individual component levels within the Department.

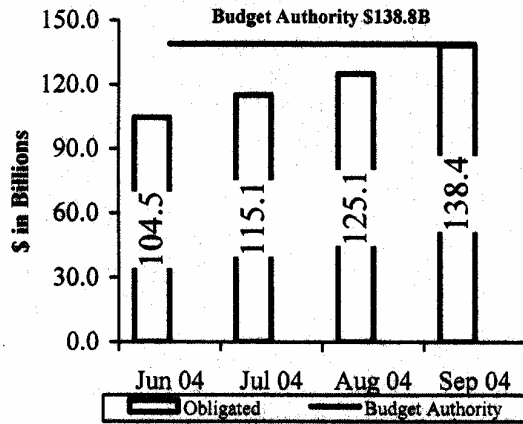
Budget and financial indicators are used to monitor and guide financial management reform and target resources to areas where DoD needs to drive better stewardship of financial resources.

Execution of Appropriations

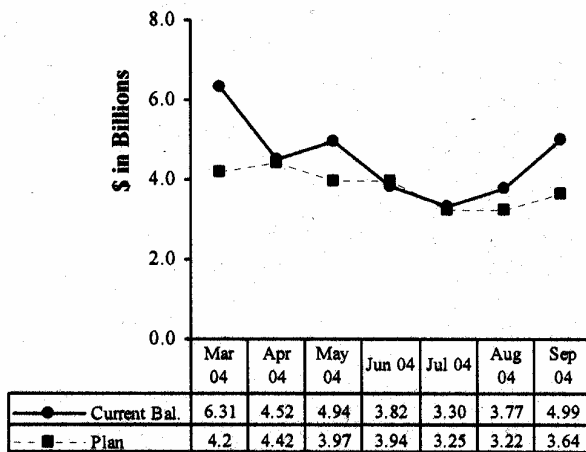
Military Personnel and Operation and Maintenance Appropriations

The Department obligated 99.9 percent of its Military Personnel Appropriations and 99.7 percent of its Operation and Maintenance Appropriations. The Department developed the following Military Personnel Appropriations and Operation and Maintenance Appropriations indicators to monitor the execution of DoD's budget and project the rate and amount of funds the Military Services obligate. The Department compares each appropriation's annual budget authority with each Service's projected obligations to ensure funds are available to finance the requirement.



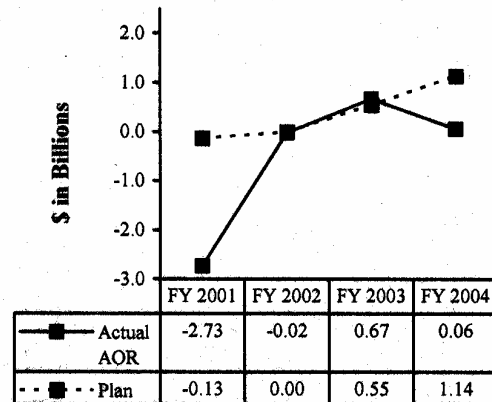
Operation and Maintenance Appropriations**Defense Working Capital Fund
Cash Management**

Cash Management within the Defense Working Capital Fund is defined as the ability to maintain sufficient liquidity to meet current obligations and accurately forecast cash requirements. The Department transferred \$3.8 billion in fiscal year 2004 to Operation and Maintenance appropriations. Cash is inflated in fiscal year 2004. Higher than normal inventory sales in fiscal year 2004, due to the global war on terror and pricing of transportation services, has generated substantial cash. However, when this inventory is replaced and with lower transportation pricing, cash will decrease significantly to pay for the restocking of inventory in fiscal year 2005. The fiscal year 2004 ending cash balance is \$4.99 billion.

**Defense Working Capital Fund
Accumulated Operating Results**

The Defense Working Capital Fund Accumulated Operating Results (AOR) indicator reflects the cumulative operating gain or loss since inception for each industrial type business area. This indicator displays the variance between the phased plan for AOR provided in the budget and the actual AOR reported in the monthly financial reports.

Overall, the revenue is above plan by \$3.2 billion and expenses are above plan by \$1.7 billion, due to the global war on terror. However, Recoverable Operating Results were reduced by \$0.8 billion to recognize the impact of cash transfers. As a result, the Department's fiscal year (FY) 2004 AOR of \$0.06 billion was less than the planned \$1.14 billion.

**Late Payments of Commercial Invoices**

The Prompt Payment Act requires that invoices be paid on time—within 30 days of receipt. This indicator highlights the degree to which the Department is able to reduce untimely commercial payments. DoD's fiscal year 2004 goal was to reduce late payments to a level not to exceed 3 percent of total commercial invoices. The Department exceeded the goal by reducing late payments to 2.6 percent. Improving this indicator reduces cost and improves DoD's relationship with suppliers.

Delinquent Accounts Receivable

The Accounts Receivable indicator highlights the amount owed to the Government by an individual, organization, public entity, foreign entity, or any other entity to include federal entities, to satisfy a debt or claim.

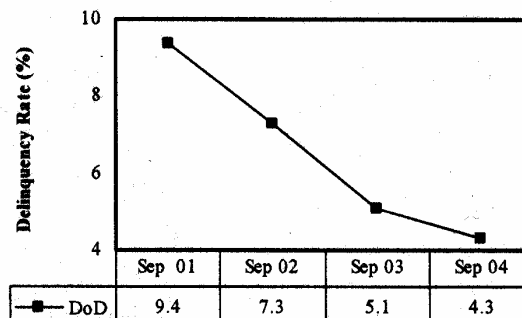
The Department's goal was to reduce delinquent receivables (more than 30 days old) by 25 percent in fiscal year 2004. The Department has two types of delinquent receivables: receivables with the public (i.e., individuals, contractors, local and foreign governments, etc.) and intragovernmental receivables with other federal government agencies.

Approximately \$4.0 billion of the \$4.9 billion delinquent public receivables were at Treasury for collection or in litigation. DoD is actively working to collect the remaining \$0.9 billion in delinquent public receivables. The Department's delinquent public receivables, for which DoD controls collecting, decreased by 21 percent in fiscal year 2004.

Delinquent intragovernmental receivables owed to the Department by other federal agencies are currently \$302 million. The Department reduced these receivables by 16 percent in fiscal year 2004.

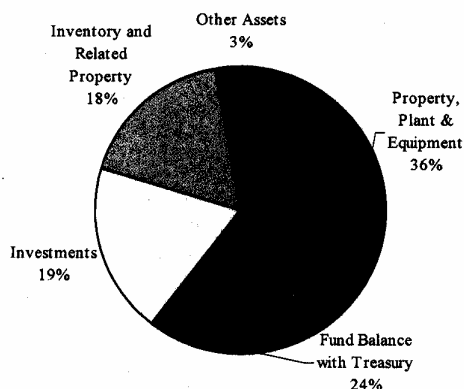
DoD Travel Card Program Individually Billed Accounts Delinquency Rates

This indicator illustrates the Department employees' record for paying their travel card invoices in a timely manner—within 60 days. The Department measures the percent of delinquent payments relative to the total billed amounts. A low delinquency rate accrues cash benefits to the Department in the form of rebates and improves the credibility of the travel and purchase card programs with both the Congress and the general public. Since fiscal year 2001, delinquency rates for individual travel accounts declined 54 percent, from 9.4 percent delinquent to 4.3 percent delinquent.



Financial Statement Analysis

Types of Assets



Assets. The Consolidated Balance Sheet shows that DoD assets as of September 30, 2004, were \$1.2 trillion, an increase of \$67.2 billion (6%) from fiscal year 2003.

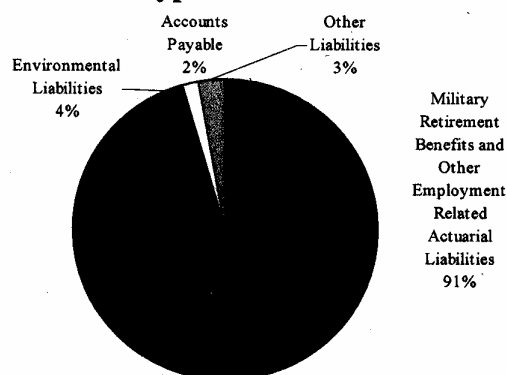
Increased funding to fight the global war on terror caused the Fund Balance with Treasury to increase \$37.5 billion.

Investments increased by \$25.9 billion primarily due to positive security cash flows for the Military Retirement Trust Fund and the Medicare Eligible Retiree Health Care Fund for retired military members and their dependents.

Assets

Asset Type	Fiscal Year 2004	Fiscal Year 2003	Change
Billions			
Property, Plant, and Equipment	\$440.9	\$446.3	-\$5.4
Fund Balance with Treasury	\$289.6	\$252.1	\$37.5
Investments	\$231.5	\$205.6	\$25.9
Inventory and Related Property	\$213.2	\$205.5	\$7.7
Other Assets	\$33.3	\$31.8	\$1.5
Total	\$1,208.5	\$1,141.3	\$67.2

Types of Liabilities



Liabilities. The Consolidated Balance Sheet shows that DoD liabilities as of September 30, 2004, were \$1.7 trillion, an increase of \$150.5 billion (10%) from fiscal year 2003.

Military Retirement Benefits and Other Employment Related Actuarial Liabilities increased \$140.1 billion primarily due to a new law which allows certain disabled military retirees to concurrently receive disability payments from the Veterans Administration and their DoD military retirement pay. Prior to this legislation, disability payments offset military retirement payments by an equal amount.

Environmental Liabilities increased by \$2.9 billion primarily due to improved accuracy in the reporting of environmental liabilities.

Accounts Payable increased by \$2.2 billion primarily due to the global war on terror.

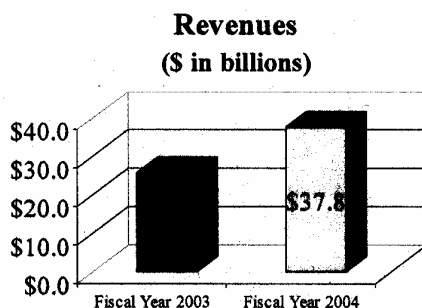
Liabilities

Liability Type	Fiscal Year 2004	Fiscal Year 2003	Change
Billions			
Military Retirement Benefits and other Employment Related Actuarial Liabilities	\$1,569.7	\$1,429.6	\$140.1
Environmental Liabilities	\$64.4	\$61.5	\$2.9
Accounts Payable	\$30.2	\$28.0	\$2.2
Other Liabilities	\$45.8	\$40.5	\$5.3
Total	\$1,710.1	\$1,559.6	\$150.5

Costs. The Consolidated Statement of Net Cost shows that the net cost of operations for the Department of Defense for fiscal year 2004 was \$605.4 billion, an increase of \$93.1 billion (18%) from fiscal year 2003. The principal reasons for this increase were the military retirement program's new legislation just discussed and the global war on terror. As indicated by the table below, increases occurred in several major military programs to support this effort. Most notably, the Department's military retirement costs increased \$52.2 billion due to increased actuarial liabilities. In addition, costs to operate, maintain, supply and transport forces increased by \$14.6 billion. The *Consolidating Statement of Net Cost* provides a more detailed breakout of the Department's costs.

Costs			
Program Type	Fiscal Year 2004	Fiscal Year 2003	Change
	Billions		
Military Personnel	\$112.3	\$108.9	\$3.4
Operation & Maintenance	\$187.1	\$172.5	\$14.6
Procurement	\$79.2	\$60.0	\$19.2
Research, Development, Test & Evaluation	\$56.8	\$51.1	\$5.7
Military Retirement	\$153.5	\$101.3	\$52.2
Other Programs	\$16.5	\$18.5	-\$2.0
Total	\$605.4	\$512.3	\$93.1

Revenues. The Consolidated Statement of Net Cost shows that the total revenues received by the Department for fiscal year 2004 were \$37.8 billion. This is a \$12.0 billion (47%) increase in revenues from fiscal year 2003. The increase in revenues was mainly due to the U.S. Treasury directing that other gains on assets be treated as revenue, whereas previously other gains were netted against costs.

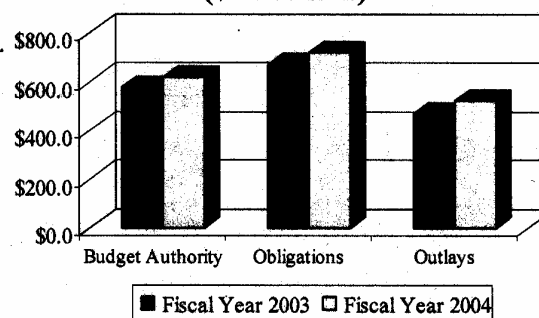


Budget Authority. This is the authority provided by law to incur financial obligations that will result in outlays. Specific forms of budget authority include appropriations, borrowing authority, contract authority, and appropriation transfers from other agencies. The Combined Statement of Budgetary Resources shows that the amount of budget authority the Department had for fiscal year 2004 was \$616.5 billion. This is a \$40.0 billion (7%) increase from fiscal year 2003. Increased funding to fight the global war on terror caused this increase and the corresponding increases to both obligations and outlays, which are discussed below.

Obligations. An obligation is a binding agreement that will result in outlays, immediately or in the future. Budgetary resources must be available before obligations can be incurred legally. The Combined Statement of Budgetary Resources shows that obligations made during fiscal year 2004 were \$720.9 billion, an increase of \$51.1 billion (8%) from fiscal year 2003.

Outlays. An outlay is a payment to liquidate an obligation (other than the repayment of debt principal). Outlays generally are equal to cash disbursements, but also are recorded for cash-equivalent transactions, such as the subsidy cost of direct loans and loan guarantees, and interest accrued on issues of public debt. Outlays are the measure of government spending. The Combined Statement of Budgetary Resources shows that outlays made during fiscal year 2004 were \$521.1 billion, an increase of \$52.6 billion (11%) from fiscal year 2003.

Statement of Budgetary Resources
(\$ in billions)



Compliance with Legal and Regulatory Requirements

Each year the Department works aggressively to comply with laws made by Congress to ensure that the federal government provides the best possible service to the American people. Among these laws are the:

- Chief Financial Officers Act of 1990
- Federal Managers' Financial Integrity Act of 1982
- Federal Financial Management Improvement Act of 1996
- Inspector General Act Amendments of 1988
- Improper Payments Information Act of 2002

Chief Financial Officers Act

The Chief Financial Officers Act requires federal agencies to prepare auditable annual financial statements. Each year, the Department prepares financial statements.

As discussed earlier, several of the Department's subordinate agencies have received a favorable audit opinion on their financial statements. However, to date, the DoD-wide statements have received a disclaimer of opinion from the auditors, which means the statements are not able to be audited.

The Department created detailed financial improvement plans. These plans identify specific corrective actions, costs, and key milestones for improving the information reported in the Department's financial statements.

To minimize the funds spent on audits until the financial statements are ready for audit, the Department implemented a rigorous five phase process in FY 2004. Phase one requires entities to identify and correct deficiencies in financial reporting. In phase two, management is required to validate that the deficiencies were corrected. After the validation, management is to assert to the auditors that the information is reliable in phase three. The assertion process contains detailed requirements for documenting the basis for asserting. In phase four, the auditors perform an assessment to determine audit readiness. If the information is ready, the auditors will perform a full audit in phase five.

The Department currently has 11 auditor identified financial statement material weaknesses. A summary of these weaknesses and their corrective status follows.

Financial Statement Weakness	Description	Status
Financial Management Systems	The DoD systemic deficiencies in financial management systems and business processes result in the inability to collect and report financial and performance information that is accurate, reliable, and timely.	The Department developed the initial version of a new business enterprise architecture. The architecture helps describe how the Department's business processes and systems will integrate to ensure that accurate and timely financial information is readily available for decision makers.
Intragovernmental Eliminations	The inability to reconcile most intragovernmental transactions results in adjustments that cannot be fully supported.	The Department is taking action internally and with other federal agencies to help resolve this issue.
Accounting Entries	The DoD continues to enter material amounts of unsupported accounting entries.	The Department has implemented a training program to minimize unsupported accounting entries and is tracking progress through the financial metrics program. Total elimination of these entries is contingent upon full implementation of the Department's business enterprise architecture, new systems, and business processes.
Fund Balance with Treasury	The Department has been unable to fully reconcile its records to those of the U.S. Treasury.	The Department strengthened internal controls for disbursements through reconciliation training and metric tracking to more accurately record disbursements. The Department also obtained legislation to clear old unreconcilable suspense accounts and check issue differences. The Department has a multi-phase program underway to enhance system functionality for improving expenditure reconciliation and reporting.
Environmental Liabilities	Guidance and audit trails are insufficient. The inventory of ranges and operational activities (landfills, open burning pits, etc.) is incomplete.	The Department issued guidance for closed sites in October 2002 and continues to issue guidance for on-going operations. Inventories of operational and non-operational ranges are complete. Additional review and validation is needed to ensure audit trails are sufficient.

Financial Statement Weakness	Description	Status
General Property, Plant and Equipment (PP&E)	The cost and depreciation of DoD General PP&E is not reliably reported due to: (a) a new accounting requirement that went into effect in FY 2003 that classifies military equipment as General PP&E (such costs were previously expensed), (b) a lack of supporting documentation for General PP&E which were purchased many years ago, and (c) most legacy property and logistics systems are not integrated with acquisition and financial systems and were not designed to capture the acquisition cost, cost of modifications and upgrades, or calculate depreciation.	The Department implemented guidance and training to improve property accountability and provide better financial reporting. The Department plans to complete valuations of all known military equipment programs by September 2005. The military equipment baseline will be updated to a single base year in fiscal year 2006. The Department plans to develop a white paper on accounting and reporting for spare parts, based on the practices of other Federal agencies and private sector organizations. The paper will be submitted to the Federal Accounting Standards Advisory Board, with resolution anticipated by March 2005.
Government Property and Material in the Possession of Contractors	The cost of DoD property and material in the possession of contractors is not reliably reported due to a lack of an integrated reporting methodology.	The Department is developing policy and processes to help correct this weakness. Implementation of new policy and the Department's business enterprise architecture will eliminate this problem. To improve accountability, accuracy, and reliability, DoD is in the process of creating an on-line government property system to be jointly used by government and industry for recording property in the possession of contractors.
Inventory	The existing inventory valuation at most activities is not reported in accordance with generally accepted accounting principles.	The Department issued a change in policy in fiscal year 2001 to begin valuing inventory at moving-average-cost to comply with historical cost valuation requirements. In fiscal year 2004, the Department chartered the Inventory and Operating Materials and Supplies Working Group to identify and develop processes and methods leading to inventory valuation based on historical costs. This effort involves assessing the Department's major logistics and financial systems—current and future—to determine the adequacy for producing historically-based valuations. The working group is developing valuation techniques where standard methods are not feasible or practical.

Financial Statement Weakness	Description	Status
Operating Materials and Supplies	The Department's systems were designed to expense materials when purchased rather than when consumed.	The Inventory and Operating Materials and Supplies Working Group is addressing this issue by examining the Department's practices, processes, and systems to determine the appropriate Department-wide business rules and systems that will correct this weakness.
Statement of Net Cost	The Statement of Net Cost is not presented by programs that align with major goals and outputs described in the DoD's strategic and performance plans required by the Government Performance and Results Act. Revenues and expenses are reported by appropriation categories because financial processes and systems do not collect costs in line with performance measures.	The implementation of the Department's business enterprise architecture will correct this weakness.
Statement of Financing	The DoD cannot reconcile budgetary obligations to net cost without making unsupported adjustments.	The implementation of the Department's business enterprise architecture will correct this weakness.

Federal Managers' Financial Integrity Act

The Federal Managers' Financial Integrity Act requires federal agencies to assess the effectiveness of management controls for program, operational, and administrative areas as well as accounting and financial management. Management controls are the organization, policies, and procedures which are considered the tools that help program and financial managers achieve results and safeguard the integrity of their programs.

Using self-assessments as the basis, this Act requires agency heads to provide an annual statement of assurance on the effectiveness of the management controls and to include material weaknesses found in management controls that warrant reporting to a higher level. The Department's fiscal year 2004 Annual Statement of Assurance is provided in the Deputy Secretary's Message at the front of this report.

Maintaining integrity and accountability in programs and operations:

- (1) is critical for good government,
- (2) demonstrates responsible stewardship over assets and resources,
- (3) promotes high-quality, responsible leadership,
- (4) enhances the sound delivery of services to customers, and
- (5) maximizes desired program outcomes.

In fiscal year 2004, the Department took numerous steps to improve the Department-wide training, awareness, communication, and emphasis for full disclosure and prompt resolution of weaknesses. Early in the year, the Department conducted a Department-wide conference attended by more than 100 representatives from 70% of the Department's components. The Controller of the Office of Management and Budget helped kick off the conference and made the case for the importance of identifying and promptly resolving material weaknesses in the functional area of financial reporting. At the conference, the Department introduced a newly designed DoD scorecard used to measure important elements of the Defense components' feeder statements. These feeder statements are essential in developing the DoD Statement of Assurance. The categories scored in the development of the DoD feeder statements are the timeliness of the statements, accuracy and completeness of the feeder reports, program execution and training to ensure robust assessments of the management controls,

full disclosure of material weaknesses, and prompt resolution of previously reported material weaknesses. The scorecard has already improved the timeliness of component feeder statements. In fiscal year 2003, only 48% of the feeder statements were received on time. This fiscal year 88% of the feeder statements were on time.

Beginning at mid-year in fiscal year 2004, the Department began using the automated system, Financial Information Progress System, to quarterly track and update the progress of corrective actions for reported weaknesses. Quarterly tracking has increased the leaderships' awareness of the importance the Department places on prompt resolution of reported weaknesses.

In fiscal year 2004, the Department conducted training briefings for 25 percent of the Defense components. In addition, the Department conducted training at the American Society of Military Comptrollers national training session, the Professional Military Comptroller School, and a Senior Executive Service orientation class.

The Department strongly encourages forthright reporting of material weaknesses in management controls on all operations important to accomplishing the mission of defending our nation from adversaries, foreign or domestic. As weaknesses are corrected, new ones may be identified and the total number of weaknesses can fluctuate. Therefore, the outstanding number of uncorrected weaknesses may not change significantly from one fiscal year to another. The Department monitors corrective activities and does not allow milestone slippage without justification by senior leaders. In fiscal year 2004, the Department notified the leaders of all DoD component activities that failure to correct material weaknesses in a timely manner is unacceptable. One of the main reasons for the inability to correct weaknesses on time has been overly optimistic projections. The Department is emphasizing the importance of using more realistic projections.

The Department uses periodic self-assessments as the basis for the annual statement of assurance and reports management control weaknesses relating to Sections 2 and 4 of the Federal Managers' Financial Integrity Act. Section 2 requires "internal accounting and administrative controls that reasonably ensure costs comply with applicable laws, assets are safeguarded, and revenue and expenses are recorded and accounted for properly." Section 4 requires that "accounting systems conform to principles, standards or related requirements prescribed by the Comptroller General."

The Department classifies management control weaknesses into 3 categories:

- 1. Section 2 Systemic Weaknesses:**
Weaknesses materially affecting management controls across organizational and program lines and usually affecting multiple DoD components.
- 2. Section 2 Material Weaknesses:**
Weaknesses materially affecting management controls that warrant reporting to a higher level and usually affect a single DoD component.
- 3. Section 4 System Nonconformance Weaknesses:** System nonconformance with the principles, standards or related requirements prescribed by the Comptroller General.

Last fiscal year, the Department had 40 uncorrected Section 2 weaknesses. In fiscal year 2004, the Department reported 17 new weaknesses and corrected 11 weaknesses, leaving 46 uncorrected weaknesses at the end of fiscal year 2004. Of the 17 new weaknesses, 1 is systemic and 16 are material weaknesses. The Department began fiscal year 2004 with 17 financial weaknesses of which 5 were systemic and 12 were material. During the year, the Department corrected 5 relating to financial issues and reported 5 as new material weaknesses, ending the year with a total of 17.

The Department identified 9 areas that affect numerous DoD components as systemic weaknesses. The Department identified the remaining 37 weaknesses as material weaknesses affecting the individual components as indicated on the table below.

In fiscal years 2002, 2003, and 2004, the Department reported one Section 4 System Nonconformance Weakness which encompasses the entire DoD financial system noncompliance with control requirements. The Department also considers DoD financial system's noncompliance as a systemic weakness affecting multiple DoD components. In addition, the auditors have identified DoD financial systems as a material weakness under the requirements of the Chief Financial Officers Act in fiscal years 2002, 2003, and 2004.

The following four tables list the weaknesses grouped differently as Section 2 (corrected or ongoing) and Section 4 (ongoing only).

Table I, Section 2 Corrected Material and Systemic Weaknesses lists 11 corrected during this fiscal year (10 material and 1 systemic weakness).

Table II, Section 2 Systemic Weaknesses – Ongoing lists the nine systemic weaknesses that remained opened at the end of fiscal year 2004, one of which was newly identified this fiscal year.

Table III, Section 2 Material Weaknesses – Ongoing lists the 37 ongoing material weaknesses. Twelve are financial issues of which five are new. Twenty-five are related to non-financial issues of which 11 were newly identified this fiscal year. For these material weaknesses, a sample of the corrective actions was selected for reporting. Each material weakness is required to have a validation as the final action to ensure that the weakness is corrected.

Table IV, Section 4 Systemic Weaknesses – Ongoing lists the 1 ongoing Section 4 system nonconformance material weakness.

Table I. Section 2 Corrected Material and Systemic Weaknesses	DoD Component
1. The actual loss of government funds could not always be fully identified because of improper disbursement transaction processing and inadequate documentation. (Material Weakness)	Defense Finance and Accounting Service
2. Due to inadequate supporting documents, freight supply payments are not properly pre-certified before they are made. (Material Weakness)	Defense Finance and Accounting Service
3. Payments less than \$2,500 are not always certified and post payment audits are not always performed on electronic vendor payments to verify that the supporting documentation is correct. (Material Weakness)	Defense Finance and Accounting Service

Table I. Section 2 Corrected Material and Systemic Weaknesses (Continued)		DoD Component
4. Adequate management controls were not in place to detect or prevent disbursements in excess of obligations. (Material Weakness)		Office of the Under Secretary of Defense for Comptroller
5. The military pay system has made invalid payments resulting in members separating from service in debt. (Material Weakness)		Defense Finance and Accounting Service
6. Better controls are needed to properly account for proceeds from submarine dismantlement scrap revenues. (Material Weakness)		Defense Threat Reduction Agency
7. Not all DoD components have completed essential continuity of operations plans. (Material Weakness)		Defense Threat Reduction Agency
8. Responsible DoD officials failed to secure host nation telecommunications agreements necessary to maximize the combat effectiveness of warfighters. (Material Weakness)		Department of the Air Force
9. Controls were not adequate to ensure that the program manager of the Joint Chemical Agent Detector—an Acquisition Category III program—reported cost breaches to the acquisition program baseline. (Material Weakness)		Office of the Under Secretary of Defense for Acquisition, Technology and Logistics
10. DoD risks improperly storing Privacy Act information on systems. (Material Weakness)		DoD Counterintelligence Field Activity
11. Acquisition oversight is not always adequate when contracting for DoD services and can result in failure to obtain the best value on individual procurements. (Systemic Weakness) [Management took action to resolve this weakness and reported it closed. However, new concerns identified by auditors during FY 2004 will be reviewed and the impact assessed.]		Office of the Under Secretary of Defense for Acquisition, Technology and Logistics

Table II. Section 2 Systemic Weaknesses -- Ongoing	
Title	1. Department of Defense Financial Management Systems and Processes
Description of Issue	The Department of Defense financial and business management systems and processes are costly to maintain and operate, not fully integrated, and do not provide information that is reliable, timely, and accurate.
Progress to Date	<p>A. Completed Milestones:</p> <ul style="list-style-type: none"> Created a portfolio management approach to review information technology investments. Incorporated the Enterprise Business Process Model into the Business Enterprise Architecture release 2.1. Established integrated goals, objectives, measures, and targets. Initiated a single Department-wide information technology registry to track all business systems.

Table II. Section 2 Systemic Weaknesses – Ongoing (Continued)	
Title	1. Department of Defense Financial Management Systems and Processes (Continued)
Progress to Date (Continued)	<p>B. Planned Milestones for FY 2005:</p> <ul style="list-style-type: none"> • Complete the Business Enterprise Architecture (BEA) Increment #1, which includes business processes in support of an unqualified audit opinion. • Perform targeted portfolio management reviews as part of the FY 2005 through FY 2006 planning, programming, and budgeting process. <p>C. Planned Milestones for Beyond FY 2005:</p> <ul style="list-style-type: none"> • Complete BEA Increment #2, which focuses on business processes that support acquisition practices, total asset visibility, accurate valuation of assets, military health care delivery, and environmental safety and occupational health. • Complete BEA Increment #3, which focuses on business processes that support the planning, programming, budgeting and execution, total force management, and installations management. • Complete targeted portfolio management reviews, which are part of the Department's planning, programming, budgeting, and execution process. <p style="text-align: center;">Correction Target Date: 4th Quarter, FY 2007</p>
Title	2. Management of Information Technology and Assurance
Description of Issue	The Department of Defense information systems are potentially vulnerable to an information warfare attack. In addition, this issue has also been reported as a "significant deficiency" under the reporting requirements of the Federal Information Security Management Act.
Progress to Date	<p>A. Completed Milestones:</p> <ul style="list-style-type: none"> • Expanded the authority of the United States Strategic Command to include network operations and information assurance. • Completed and updated the Department of Defense policies addressing public key infrastructure and enterprise-wide certification requirements for information assurance / technology professionals. • Completed the draft revision and informal coordination of the certification and accreditation policy, which improves compliance and provides an enterprise management capability. • Developed and piloted an automated security certification and accreditation process for information systems. Began the expansion to more robust web based design using shared information and services that deliver improved functionality by interconnecting data transactions into a common database. • Awarded the Department of Defense-wide enterprise license for an information assurance vulnerability scanning tool.

Table II. Section 2 Systemic Weaknesses – Ongoing (Continued)	
Title	2. Management of Information Technology and Assurance (Continued)
Progress to Date (Continued)	<p>B. Planned Milestones for FY 2005:</p> <ul style="list-style-type: none"> Revise the security certification and accreditation policy in order to improve compliance and to provide an enterprise management capability. Incorporate a revised certification and accreditation process, including vulnerability management and complete the piloting process. Continue modular development and deployment of additional services to support the information assurance processes, e.g., investment and resource management. Award the enterprise licenses for automated IA tools to patch vulnerabilities and prevent malicious modification of Operating Systems. <p>C. Planned Milestones for Beyond FY 2005:</p> <ul style="list-style-type: none"> Provide the United States Strategic Command real-time situational awareness of the Department of Defense posture. Provide information assurance management tools as a core enterprise service. <p>Correction Target Date: 3rd Quarter, FY 2007</p>
Title	3. Environmental Liabilities
Description of Issue	The Department of Defense has not developed the policies, procedures, and methodologies needed to ensure that cleanup costs for all of its ongoing and inactive or closed operations are identified, consistently estimated, and appropriately reported. Site inventories and cost methodologies to identify budget requirements and financial liabilities continue to need improvement.
Progress to Date	<p>A. Completed Milestones:</p> <ul style="list-style-type: none"> Provided guidance to accomplish an initial operational range inventory. Reported the operational range inventory to Congress in February of FY 2004. Completed a real property inventory business process reengineering and presented the concept for Department of Defense-wide review. Revised the Financial Management Regulation for liability recognition and reporting for operational ranges and munitions response areas. Published the directive entitled “Sustainment of Ranges and Operating Areas,” that requires reporting of environmental remediation liabilities. Issued planning guidance that requires the assessment of environmental condition of the operational ranges.

Table II. Section 2 Systemic Weaknesses -- Ongoing	
3. Environmental Liabilities (Continued)	
Progress to Date (Continued)	<p>B. Planned Milestones for FY 2005:</p> <ul style="list-style-type: none"> • Develop an inventory of non-Defense Environmental Restoration Program activities. • Develop the non-Defense Environmental Restoration Program liability estimates. • Assess the progress made by the Military Services in reporting complete, accurate, and supported environmental liability data during the review of the FY 2004 financial statements. <p>C. Planned Milestones for Beyond FY 2005:</p> <ul style="list-style-type: none"> • Update the site inventories and environmental liability estimates of the Defense Environmental Restoration and the non-Defense Environmental Restoration Programs. • Assess the progress made by the Military components in reporting complete, accurate, and supported environmental liability data during review of the FY 2005 financial statements. <p style="text-align: center;">Correction Target Date: 1st Quarter, FY 2006</p>
Title	4. Personnel Security Investigations Program
Description of Issue	The Department of Defense hiring is adversely affected because personnel security investigations are backlogged.
Progress to Date	<p>A. Completed Milestones:</p> <ul style="list-style-type: none"> • Signed an interagency agreement with the Office of Personnel Management to allow the Defense Security Service to use the Office of Personnel Management computer system for tracking and controlling the Department of Defense personnel security investigations and case processing. • Realigned 200 overhead positions in the Defense Security Service to investigator positions, redesigned the organizational structure, closed offices that lacked sufficient work, and deployed "tiger teams" to conduct overseas investigations. Reduced the number of pending cases in the case control management system from over 400,000 to less than 57,000. • Reinforced quality reviews of contractor work. Issued to the contractors cure letters for failing to meet agreed upon timelines. Took back a number of investigations from the contractors. <p>B. Planned Milestones for FY 2005:</p> <ul style="list-style-type: none"> • 50 percent of the investigations are submitted within the agreed upon timeframes.

Federal Financial Management Improvement Act

The Federal Financial Management Improvement Act requires federal agencies to conform to the United States Government Standard General Ledger, comply with all applicable federal accounting standards, establish financial management systems that meet government-wide standards and requirements, and support full disclosure of federal financial data, including the costs of federal programs and activities.

The Department does not fully comply with these requirements. However, as part of the Business Management Modernization Program, the Department teamed with IBM to develop an initial version of the business enterprise architecture in April 2003 to help transform business processes and systems. The architecture helps describe how the Department's business processes and systems will integrate to ensure accurate and timely financial information is readily available for decision makers. When the architecture is fully implemented, the Department expects to meet all the requirements of this Act.

Inspector General Act Amendments

The Inspector General Act of 1978, as amended, requires an explanation for all audit reports with recommendations open for more than 1 year. As of September 30, 2004, the Department had 212 audit reports open for more than 1 year. We are implementing many of these recommendations and the savings are estimated to be \$7.9 billion. The Department has already closed out and implemented recommendations from 130 audit reports in fiscal year 2004 with claimed monetary benefits of approximately \$255 million.

Improper Payments Information Act

The Improper Payments Information Act of 2002, as implemented by the Office of Management and Budget, requires federal agencies to review annually all its programs and activities and identify those which may be susceptible to significant erroneous payments.

DoD's fiscal year 2004 survey did not identify any programs or activities where erroneous payments exceeded the established thresholds (i.e., an error rate greater than 2.5 percent and erroneous payments in excess of \$10 million), nor were any found to be susceptible to significant risk. Although the Department is currently under these thresholds for all its programs and activities, the Office of Management and Budget established an additional requirement that all programs initially identified in Section 57, "Information on Erroneous Payments," of Circular A-11, perform all the prescribed steps outlined in its guidance. These steps include the production of a statistically valid estimate of the erroneous payments, implementing a plan to reduce the amount and reporting to the President and Congress on progress. For the Department of Defense, these programs are Military Health Benefits and Military Retirement. The results of the review of these programs are highlighted below.

Military Health Benefits. The military health benefits program has numerous prepayment and post payment controls built into the claims processing system to minimize improper payments. One control is the claims edit system, which rebundles services that should be billed under a single code. Procedure unbundling occurs when two or more procedure codes are used to describe a service when a single comprehensive code exists that accurately describes all services performed. This is a poor practice, one that seeks to increase reimbursement.

An example of this practice is laboratory test unbundling. A laboratory can perform numerous tests from a single blood sample. Separate charges for each test inflates the billing, as illustrated here:

Unbundled Billing

Cholesterol, serum (82465):	\$ 6.98
Lipoprotein (HDL cholesterol) (83718):	\$13.14
Triglycerides (84478):	<u>\$ 9.24</u>
TOTAL:	<u>\$29.36</u>

Rebundled (Proper) Billing

Lipid panel (80061) (includes cholesterol, lipoprotein and triglycerides):	<u>\$21.50</u>
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A cost avoidance of \$87.6 million was realized in fiscal year 2003 as a result of the military health benefits program rebundling edits. Anticipating that the trend will continue, the Department projects approximately a 10% increase in the amount of the cost avoidance for fiscal year 2004.

The Department projected \$100.1 million of improper payments (underpayments and overpayments) for the military health benefits program – purchased care program – in fiscal year 2004. This represents an error rate of approximately 2.16% of the \$4.6 billion in military health benefits program payments made during fiscal year 2004. The 2.16% is a preliminary payment error rate. The final payment error rate is not available until the administrative process associated with the audits has been completed, which is targeted for September 2005. Historically, the final figure has been less than the 2% threshold allowed by contract. In support of this position, last year's DoD Performance and Accountability Report listed the preliminary payment error rate for fiscal year 2003 as 1.36%. The final payment error rate for fee-for-service claims was 0.85%.

Although health benefit dollars are used to also pay for expenditures incurred under the U.S. Family Health Plans and other areas, these were not identified as being susceptible to significant erroneous payments. Therefore, they are excluded.

Military Retirement. The Department conducts various types of prepayment and postpayment reviews for military retirement payments. One example is that all payments more than \$9,000 made

to retirees and more than \$5,500 made to annuitants are reviewed. Another example is a monthly review of the retired military pay file for similar social security numbers, which helps minimize duplicate payments.

The Department projected \$34.1 million of improper payments (underpayments and overpayments) for the Military Retirement Program in fiscal year 2004. This represents an error rate of 0.0952% of the \$35.8 billion in military retirement payments made during fiscal year 2004.

For further reporting details about the Improper Payments Information Act, see Appendix A.

President's Management Agenda



White House photo by Eric Draper

successful implementation of the President's Management Agenda.

The Department continues to make progress accomplishing President George W. Bush's Management Agenda. The goal of this Agenda is to improve performance in five key federal management areas. Following is a brief description of each initiative and efforts the Department has undertaken thus far toward

Strategic Human Capital Management. Even though DoD is engaged in major endeavors overseas, transforming the Department continues to be a priority, as evidenced by the Department's efforts in seeking a National Security Personnel System. Without doubt the flexibility inherent in this system would enable the Department to respond to threats to national interests, while continuing to provide benefits to both DoD military and civilian personnel and link both basic pay and performance incentives directly to the performance measurement process. Further, DoD has developed a Human Resources Strategy which was "cascaded" throughout the Department to ensure that complementary actions are taken across the Department. During FY 2004, the Department also began preparing for the 2005 round of Base Realignment and Closure. Research was conducted to compare current DoD transition tools and outplacement activities to those used in private industry in an effort to minimize adverse effects on our mission and human resources. We instituted formal gap analyses of core mission and critical support occupations. These occupations are analyzed and reported quarterly. No significant gaps have been identified. The Department has also forwarded a Workforce Restructuring Plan to the Office of Management and Budget, describing the organizational plans to meet workforce needs.

Competitive Sourcing. The Department has a goal to compete 226,000 positions by year 2009. DoD far exceeded the Office of Management and Budget's goal of competing 67,800 positions by fiscal year 2004; more than 84,000 positions were competed with an estimated

savings of \$9.3 billion dollars. In addition, the Department has plans underway for competing more than 9,000 additional positions.

Improving Financial Performance. The Department has three primary initiatives underway to improve its financial performance: the Business Management Modernization Program, Financial Improvement Initiative, and the Financial Management Balanced Scorecard. These initiatives directly respond to financial improvement plans required by the Office of Management and Budget's guidance for the Chief Financial Officer Financial Management 5-Year Plan and Financial Management Systems Plan, as well as the Federal Financial Management Improvement Act's requirement for remediation plans.

Expanding Electronic Government. Of the 25 initiatives identified by the President's Management Council, 18 involve DoD activities. The Department is taking an active role in many of those initiatives. In conjunction with the Office of Management and Budget, the Department will improve management processes relating to the creation and description of business cases for information technology initiatives. The DoD Chief Information Officer is also working closely with Office of Management and Budget on other scorecard elements such as the enterprise architecture, business cases for information technology investments, program management, and security. During the past fiscal year, the Department improved a substantial number of business cases for information technology investments, and made progress on its integrated information technology architectures. The Department also strengthened its information technology security program. The Department is actively engaged with the General Services Administration in the Federal Smart Buy program, which is based on DoD's award-winning Enterprise Software Initiative that has achieved \$1.6 billion in cost avoidance since its inception in 1998.

Budget and Performance Integration. The Department uses meaningful performance metrics in managing and justifying program

resources. The year 2005 President's budget included performance metrics (to include a Program Assessment Rating Tool for 15 programs) for 40 percent of the Department's resources. Additional efforts are underway to integrate performance metrics into all phases of the Department's planning, programming, budgeting, and execution process.

Summary. The Office of Management and Budget scores the initiatives for each government agency. The scorecard employs a simple grading system: green for success, yellow for mixed results, and red for unsatisfactory. The Department's progress and current status ratings supporting the President's management goals in these five key federal management areas are depicted in the following chart. Further information is available at <http://www.results.gov>.

The Department cascaded the scoring process to the Services and Defense Agencies this year. The Department has empowered all defense organizations to apply the principles of the President's Management Agenda in a results-oriented manner for their benefit, thus ensuring Department-wide implementation and institutionalization.

The Department is making every effort to implement policies and procedures that accentuate efficiency and sound management principles. The Department is confident this will be reflected positively as it progresses through the coming years.

President's Management Agenda Initiative	Current Status	Progress
Strategic Human Capital Management	Yellow	Green
Competitive Sourcing	Green	Yellow
Improving Financial Performance	Red	Yellow
Expanding Electronic Government	Red	Green
Budget and Performance Integration	Yellow	Green

Message from the Chief Financial Officer

November 15, 2004

The past year has been an important and challenging year for the Department of Defense. We have continued to vigorously fight the global war on terror, while simultaneously transforming the Department to accomplish our mission with ever greater effectiveness.

Our ability to defend our citizens and allies is heavily dependent on being able to obtain and supply the proper resources to our warfighters. Every dollar is important and the way we manage those dollars makes a difference in how successfully we accomplish our mission.

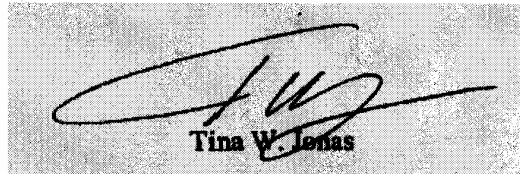
I realize the important responsibility that the Department's financial community has in supplying financial information to those who make decisions about how best to equip and deploy our troops. For this reason, I am committed to transforming the Department's financial community. We have a long way to go, but we are well on the way.

During the past year, the Department made progress on many fronts. We improved the timeliness of our reporting by preparing quarterly financial statements in 21 days and by completing the year-end reporting process in 45 days. During this time, we improved the quality of financial statement data, as evidenced by an increasing number of favorable audit results.

Looking ahead, I see a need for action that is both immediate and long term. Through the Business Management Modernization Program, the Department is overhauling the processes and tools that are used to conduct business. This is an enormous effort that will take time, but will yield tremendous benefits across the entire Department.

Our long term modernization, however, does not stop us from taking immediate action. Each major component within DoD has prepared improvement plans to identify major challenges in financial management and reporting. These plans are key tools for identifying targets of opportunity as we move into a transformed business environment.

I am fully committed to improving the Department's financial management. I will ensure we continue to build on the accomplishments in achieving an unqualified audit opinion on our financial statements and ultimately providing timely, accurate, and reliable financial information to our decision makers.



Tina W. Lenas

Principal Financial Statements and Notes

The principal financial statements included in this report have been prepared in accordance with the requirements of the Chief Financial Officers Act of 1990 (P.L. 101-576), the Government Management Reform Act of 1994 and the Office of Management and Budget's (OMB) Bulletin 01-09, "Form and Content of Agency Financial Statements." The responsibility for the integrity of the financial information included in these statements rests with management of the U.S. Department of Defense. The Department's fiscal years 2004 and 2003 principal financial statements were audited by the Office of Inspector General. The auditors' report accompanies the principal statements.

The Department's principal financial statements for fiscal years 2004 and 2003 consisted of the following:

The Consolidated Balance Sheet, which present as of September 30, 2004 and 2003 those resources owned or managed by DoD which are available to provide future economic benefits (assets); amounts owed by DoD that will require payments from those resources or future resources (liabilities) and residual amounts retained by DoD, comprising the difference (net position).

The Consolidated Statement of Net Cost, which present the net cost of DoD operations for the years ended September 30, 2004 and 2003. DoD's net cost of operations includes the gross costs incurred by DoD less any exchange revenue earned from DoD activities.

The Consolidated Statement of Changes in Net Position, which present the change in DoD's net position resulting from the net cost of DoD operations, budgetary financing sources other than exchange revenues and other financing sources for the years ended September 30, 2004 and 2003.

The Combined Statement of Budgetary Resources, which present the budgetary resources available to DoD during FY 2004 and 2003, the status of these resources at September 30, 2004 and 2003, and the outlay of budgetary resources for the years ended September 30, 2004 and 2003.

The Combined Statement of Financing, which reconcile the net cost of operations with the

obligation of budgetary resources for the years ended September 30, 2004 and 2003.

The Consolidated Statement of Custodial Activity, which present the sources and disposition of nonexchange revenues collected or accrued by DoD on behalf of other recipient entities for the years ended September 30, 2004 and 2003.

Limitations of Financial Statements. The following limitations apply to the preparation of the fiscal year 2004 financial statements:

The principal financial statements have been prepared to report the financial position and results of operations of the Department of Defense, pursuant to the requirements of 31 U.S.C. 3515 (b). The statements are prepared from the books and records of the Department in accordance with OMB Bulletin 01-09 and to the extent possible generally accepted accounting principles. The statements are in addition to the financial reports used to monitor and control budgetary resources which are prepared from the same books and records.

The statements should be read with the realization that they are for a component of the U.S. Government, a sovereign entity.

Department of Defense
Agency Wide
CONSOLIDATED BALANCE SHEET
As of September 30, 2004 and 2003
(\$ in Millions)

	2004 Consolidated	2003 Consolidated Restated
ASSETS (Note 2)		
Intragovernmental:		
Fund Balance with Treasury (Note 3)		
Entity	\$ 287,685.5	\$ 251,544.1
Non-Entity Seized Iraqi Cash	113.4	278.1
Non-Entity-Other	1,800.0	239.8
Investments (Note 4)	231,069.7	205,376.0
Accounts Receivable (Note 5)	1,118.3	1,066.6
Other Assets (Note 6)	1,011.9	105.0
Total Intragovernmental Assets	\$ 522,798.8	\$ 458,609.6
Cash and Other Monetary Assets (Note 7)	\$ 2,178.1	\$ 1,534.9
Accounts Receivable (Note 5)	7,427.8	7,299.9
Loans Receivable (Note 8)	70.7	64.0
Inventory and Related Property (Note 9)	213,219.4	205,544.6
General Property, Plant and Equipment (Note 10)	440,898.6	446,308.9
Investments (Note 4)	406.5	217.8
Other Assets (Note 6)	21,486.3	21,729.6
TOTAL ASSETS	\$ 1,208,486.2	\$ 1,141,309.3
LIABILITIES (Note 11)		
Intragovernmental:		
Accounts Payable (Note 12)	\$ 1,888.4	\$ 101.4
Debt (Note 13)	591.8	698.2
Environmental Liabilities (Note 14)	0.0	0.0
Other Liabilities (Note 15 & Note 16)	10,726.9	9,739.1
Total Intragovernmental Liabilities	\$ 13,207.1	\$ 10,538.7
Accounts Payable (Note 12)	\$ 28,309.0	\$ 27,863.8
Military Retirement Benefits and Other Employment-Related	1,569,704.7	1,429,565.5
Actuarial Liabilities (Note 17)		
Environmental Liabilities (Note 14)	64,367.2	61,490.6
Loan Guarantee Liability (Note 8)	34.4	25.9
Other Liabilities (Note 15 and Note 16)	34,491.2	30,154.0
Debt Held by Public	0.0	0.0
TOTAL LIABILITIES	\$ 1,710,113.6	\$ 1,559,638.5
NET POSITION		
Unexpended Appropriations (Note 18)	\$ 243,813.9	\$ 218,869.5
Cumulative Results of Operations	(745,441.3)	(637,198.7)
TOTAL NET POSITION	\$ (501,627.4)	\$ (418,329.2)
TOTAL LIABILITIES AND NET POSITION	\$ 1,208,486.2	\$ 1,141,309.3

Department of Defense**Agency Wide****CONSOLIDATED STATEMENT OF NET COST****For the periods ended September 30, 2004 and 2003****(\$ in Millions)**

	2004 Consolidated	2003 Consolidated
Program Costs		
Intragovernmental Gross Costs	\$ 23,574.5	\$ 11,748.3
(Less: Intragovernmental Earned Revenue)	(15,429.0)	(13,239.0)
Intragovernmental Net Costs	\$ 8,145.5	\$ (1,490.7)
Gross Costs With the Public	619,573.8	526,288.4
(Less: Earned Revenue From the Public)	(22,354.4)	(12,507.1)
Net Costs With the Public	\$ 597,219.4	\$ 513,781.3
Total Net Cost	\$ 605,364.9	\$ 512,290.6
Cost Not Assigned to Programs	0.0	0.0
(Less: Earned Revenue Not Attributable to Programs)	0.0	0.0
Net Cost of Operations	\$ 605,364.9	\$ 512,290.6

Department of Defense**Agency Wide****CONSOLIDATED STATEMENT OF CHANGES IN NET POSITION****For the periods ended September 30, 2004 and 2003****(\$ in Millions)**

	2004 Consolidated	2003 Consolidated Restated
CUMULATIVE RESULTS OF OPERATIONS		
Beginning Balances	\$ (621,610.7)	\$ (946,947.7)
Prior period adjustments (+/-)		
Prior Period Adjustments - Restated (+/-)	(15,588.0)	10,534.8
Beginning Balance, Restated	(637,198.7)	(936,412.9)
Prior Period Adjustments - Not Restated (+/-)	699.5	383,074.9
Beginning Balances, as adjusted	(636,499.2)	(553,338.0)
Budgetary Financing Sources:		
Appropriations received	0.0	0.0
Appropriations transferred-in/out (+/-)	0.0	0.0
Other adjustments (rescissions, etc) (+/-)	0.0	(13.0)
Appropriations used	478,621.1	431,548.0
Nonexchange revenue	1,469.7	931.2
Donations and forfeitures of cash and cash equivalents	7.0	24.4
Transfers-in/out without reimbursement (+/-)	10,568.6	1,329.2
Other budgetary financing sources (+/-)	4,511.5	(2,867.4)
Other Financing Sources:		
Donations and forfeitures of property	0.4	4.6
Transfers-in/out without reimbursement (+/-)	(2,848.6)	(6,702.1)
Imputed financing from costs absorbed by others	4,092.5	3,866.9
Other (+/-)	0.6	308.1
Total Financing Sources	496,422.8	428,429.9
Net Cost of Operations (+/-)	605,364.9	512,290.6
Ending Balances	\$ (745,441.3)	\$ (637,198.7)

Department of Defense

Agency Wide

CONSOLIDATED STATEMENT OF CHANGES IN NET POSITION

For the periods ended September 30, 2004 and 2003

(\$ in Millions)

	2004 Consolidated	2003 Consolidated Restated
UNEXPENDED APPROPRIATIONS		
Beginning Balances	\$ 192,955.8	\$ 177,282.6
Prior period adjustments (+/-)		
Prior Period Adjustments - Restated (+/-)	25,913.7	0.0
Beginning Balance, Restated	218,869.5	177,282.6
Prior Period Adjustments - Not Restated (+/-)	0.0	0.0
Beginning Balances, as adjusted	218,869.5	177,282.6
Budgetary Financing Sources:		
Appropriations received	512,194.5	477,036.7
Appropriations transferred-in/out (+/-)	485.6	1,217.8
Other adjustments (rescissions, etc) (+/-)	(9,114.6)	(5,137.1)
Appropriations used	(478,621.1)	(431,530.5)
Nonexchange revenue	0.0	0.0
Donations and forfeitures of cash and cash equivalents	0.0	0.0
Transfers-in/out without reimbursement (+/-)	0.0	0.0
Other budgetary financing sources (+/-)	0.0	0.0
Other Financing Sources:		
Donations and forfeitures of property	0.0	0.0
Transfers-in/out without reimbursement (+/-)	0.0	0.0
Imputed financing from costs absorbed by others	0.0	0.0
Other (+/-)	0.0	0.0
Total Financing Sources	24,944.4	41,586.9
Net Cost of Operations (+/-)		
Ending Balances	\$ 243,813.9	\$ 218,869.5

Department of Defense

Agency Wide

COMBINED STATEMENT OF BUDGETARY RESOURCES

For the periods ended September 30, 2004 and 2003

(\$ in Millions)

	2004 Combined	2003 Combined
BUDGETARY FINANCING ACCOUNTS		
BUDGETARY RESOURCES		
Budget Authority:		
Appropriations received	\$ 582,010.7	\$ 546,761.4
Borrowing authority	0.1	0.0
Contract authority	34,855.8	28,109.0
Net transfers (+/-)	(519.3)	1,000.3
Other	0.0	0.0
Unobligated balance:		
Beginning of period	256,659.0	217,722.3
Net transfers, actual (+/-)	782.0	204.3
Anticipated Transfers Balances	0.0	0.0
Spending authority from offsetting collections:		
Earned	0.0	0.0
Collected	146,274.3	135,587.2
Receivable from Federal sources	(79.7)	(714.6)
Change in unfilled customer orders	0.0	0.0
Advance received	360.5	(30.6)
Without advance from Federal sources	980.0	11,000.9
Anticipated for the rest of year, without advances	0.0	0.0
Transfers from trust funds	0.0	0.0
Subtotal	147,535.1	145,842.9
Recoveries of prior year obligations	33,681.9	22,841.9
Temporarily not available pursuant to Public Law	(10.0)	0.0
Permanently not available	(40,338.0)	(33,730.4)
Total Budgetary Resources	\$ 1,014,657.3	\$ 928,751.7

Department of Defense**Agency Wide****COMBINED STATEMENT OF BUDGETARY RESOURCES****For the periods ended September 30, 2004 and 2003****(\$ in Millions)**

	2004 Combined	2003 Combined
STATUS OF BUDGETARY RESOURCES		
Obligations incurred:		
Direct	\$ 568,053.7	\$ 522,562.4
Reimbursable	152,658.9	147,147.8
Subtotal	720,712.6	669,710.2
Unobligated balance:		
Apportioned	58,631.0	55,052.0
Exempt from apportionment	183,488.1	180,704.3
Other available	0.3	(0.1)
Unobligated Balances Not Available	51,825.3	23,285.3
Total, Status of Budgetary Resources	\$ 1,014,657.3	\$ 928,751.7
Relationship of Obligations to Outlays:		
Obligated Balance, Net - beginning of period	\$ 214,371.9	\$ 181,919.4
Obligated Balance transferred, net (+/-)	(14.1)	(23.9)
Obligated Balance, Net - end of period:		
Accounts receivable	(10,136.8)	(10,216.4)
Unfilled customer order from Federal sources	(39,402.0)	(38,422.1)
Undelivered orders	228,801.3	213,597.8
Accounts payable	53,470.6	49,412.6
Outlays:		
Disbursements	667,755.1	604,105.8
Collections	(146,634.7)	(135,556.8)
Subtotal	521,120.4	468,549.0
Less: Offsetting receipts	(46,546.4)	(43,294.0)
Net Outlays	\$ 474,574.0	\$ 425,255.0

Department of Defense**Agency Wide****COMBINED STATEMENT OF BUDGETARY RESOURCES****For the periods ended September 30, 2004 and 2003****(\$ in Millions)**

	2004 Combined	2003 Combined
NONBUDGETARY FINANCING ACCOUNTS		
BUDGETARY RESOURCES		
Budget Authority:		
Appropriations received	\$ 0.0	\$ 0.0
Borrowing authority	114.6	50.5
Contract authority	0.0	0.0
Net transfers (+/-)	0.0	0.0
Other	0.0	0.0
Unobligated balance:		
Beginning of period	21.8	104.0
Net transfers, actual (+/-)	0.0	0.0
Anticipated Transfers Balances	0.0	0.0
Spending authority from offsetting collections:		
Earned	0.0	0.0
Collected	17.4	56.2
Receivable from Federal sources	(0.6)	(90.0)
Change in unfilled customer orders	0.0	0.0
Advance received	0.0	0.0
Without advance from Federal sources	47.2	35.8
Anticipated for the rest of year, without advances	0.0	0.0
Transfers from trust funds	0.0	0.0
Subtotal	64.0	2.0
Recoveries of prior year obligations	0.0	1.9
Temporarily not available pursuant to Public Law	0.0	0.0
Permanently not available	20.7	(0.2)
Total Budgetary Resources	\$ 221.1	\$ 158.2

Department of Defense
Agency Wide
COMBINED STATEMENT OF BUDGETARY RESOURCES
For the periods ended September 30, 2004 and 2003
(\$ in Millions)

	2004 Combined	2003 Combined
STATUS OF BUDGETARY RESOURCES		
Obligations incurred:		
Direct	\$ 196.6	\$ 136.4
Reimbursable	0.0	0.0
Subtotal	196.6	136.4
Unobligated balance:		
Apportioned	1.4	1.3
Exempt from apportionment	0.0	0.0
Other available	0.0	(0.1)
Unobligated Balances Not Available	23.1	20.6
Total, Status of Budgetary Resources	\$ 221.1	\$ 158.2
Relationship of Obligations to Outlays:		
Obligated Balance, Net - beginning of period	\$ 29.9	\$ (95.1)
Obligated Balance transferred, net (+/-)	0.0	0.0
Obligated Balance, Net - end of period:		
Accounts receivable	0.0	(0.6)
Unfilled customer order from Federal sources	(83.1)	(35.8)
Undelivered orders	238.8	66.3
Accounts payable	0.0	0.0
Outlays:		
Disbursements	24.1	63.6
Collections	(17.4)	(56.2)
Subtotal	6.7	7.4
Less: Offsetting receipts	0.0	0.0
Net Outlays	\$ 6.7	\$ 7.4

Department of Defense**Agency Wide****COMBINED STATEMENT OF FINANCING****For the periods ended September 30, 2004 and 2003****(\$ in Millions)**

	2004 Combined	2003 Combined
Resources Used to Finance Activities:		
Budgetary Resources Obligated		
Obligations incurred	\$ 720,909.2	\$ 669,846.5
Less: Spending authority from offsetting collections and recoveries (-)	(181,281.0)	(168,688.6)
Obligations net of offsetting collections and recoveries	539,628.2	501,157.9
Less: Offsetting receipts (-)	(46,546.4)	(43,294.0)
Net obligations	493,081.8	457,863.9
Other Resources		
Donations and forfeitures of property	0.4	4.6
Transfers in/out without reimbursement (+/-)	(2,848.6)	(6,702.1)
Imputed financing from costs absorbed by others	4,092.5	3,866.9
Other (+/-)	0.6	308.1
Net other resources used to finance activities	1,244.9	(2,522.5)
Total resources used to finance activities	494,326.7	455,341.4
Resources Used to Finance Items not Part of the Net Cost of Operations		
Change in budgetary resources obligated for goods, services and benefits ordered but not yet provided		
Undelivered Orders (-)	(13,925.6)	(37,435.1)
Unfilled Customer Orders	1,387.4	11,006.1
Resources that fund expenses recognized in prior periods	(2,637.4)	(686.3)
Budgetary offsetting collections and receipts that do not affect net cost of operations	2,645.4	929.3
Resources that finance the acquisition of assets	(86,943.6)	(72,984.9)
Other resources or adjustments to net obligated resources that do not affect net cost of operations		
Less: Trust or Special Fund Receipts Related to Exchange	(10.0)	0.0
Other (+/-)	2,855.5	6,623.6
Total resources used to finance items not part of the net cost of operations	(96,628.3)	(92,547.3)
Total resources used to finance the net cost of operations	397,698.4	362,794.1

Department of Defense**Agency Wide****COMBINED STATEMENT OF FINANCING****For the periods ended September 30, 2004 and 2003****(\$ in Millions)**

	2004 Combined	2003 Combined
Components of the Net Cost of Operations that will not Require or Generate Resources in the Current Period:		
Components Requiring or Generating Resources in Future Period:		
Increase in annual leave liability	514.8	662.7
Increase in environmental and disposal liability	3,864.6	2,033.6
Upward/Downward reestimates of credit subsidy expense (+/-)	14.9	0.0
Increase in exchange revenue receivable from the public (-)	(73.8)	(6.6)
Other (+/-)	139,064.9	95,403.2
Total components of Net Cost of Operations that will require or generate resources in future periods	143,385.4	98,092.9
Components not Requiring or Generating Resources:		
Depreciation and amortization	42,249.2	55,274.7
Revaluation of assets or liabilities (+/-)	(5,712.6)	6,299.4
Other (+/-)		
Trust Fund Exchange Revenue	(24,285.4)	(23,792.5)
Cost of Goods Sold	41,421.8	0.0
Operating Material & Supplies Used	4,655.9	0.0
Other	5,952.2	13,622.0
Total components of Net Cost of Operations that will not require or generate resources	64,281.1	51,403.6
Total components of net cost of operations that will not require or generate resources in the current period	207,666.5	149,496.5
Net Cost of Operations	605,364.9	512,290.6

Department of Defense**Agency Wide****COMBINED STATEMENT OF CUSTODIAL ACTIVITY****For the periods ended September 30, 2004 and 2003****(\$ In Millions)**

	2004 Combined	2003 Combined
SOURCE OF COLLECTIONS		
Deposits by Foreign Governments	\$ 11,237.5	\$ 9,971.6
Seized Iraqi Cash	118.3	808.9
Other Collections	0.0	0.0
Total Cash Collections	\$ 11,355.8	\$ 10,780.5
Accrual Adjustments (+/-)	\$ 0.9	\$ 0.7
Total Custodial Collections	\$ 11,356.7	\$ 10,781.2
DISPOSITION OF COLLECTIONS		
Disbursed on Behalf of Foreign Governments and International Organizations	\$ 9,998.8	\$ 10,118.8
Seized Assets Disbursed on behalf of Iraqi People	283.1	530.8
Increase (Decrease) in Amounts to be Transferred	1,239.5	(146.5)
Collections Used for Refunds and Other Payments	0.0	0.0
Retained by The Reporting Entity	0.0	0.0
Seized Assets Retained for Support of the Iraqi People	(164.7)	278.1
Total Disposition of Collections	\$ 11,356.7	\$ 10,781.2
NET CUSTODIAL COLLECTION ACTIVITY	\$ 0.0	\$ 0.0

Note 1. Significant Accounting Policies**1.A. Basis of Presentation**

These financial statements have been prepared to report the financial position and results of operations of the Department of Defense (DoD), as required by the "Chief Financial Officers Act of 1990," expanded by the "Government Management Reform Act of 1994," and other appropriate legislation. The financial statements have been prepared from the books and records of the Department in accordance with the "DoD Financial Management Regulation," Office of Management and Budget Bulletin No. 01-09, "Form and Content of Agency Financial Statements," and to the extent possible generally accepted accounting principles (GAAP). The accompanying financial statements account for all resources for which the Department is responsible. Information relative to classified assets, programs, and operations has been excluded from the statements or otherwise aggregated and reported in such a manner that it is no longer classified.

The Department is unable to fully implement all elements of GAAP and Office of Management and Budget Bulletin No. 01-09 due to limitations of its financial management processes and systems, including nonfinancial systems and processes that feed into the financial statements. The Department derives its reported values and information for major asset and liability categories largely from nonfinancial systems, known as feeder systems, such as inventory systems and logistic systems. These systems were designed to support reporting requirements that focus on maintaining accountability over assets and reporting the status of federal appropriations rather than preparing financial statements in accordance with GAAP. The Department continues to implement process and system improvements addressing these limitations.

1.B. Mission of the Reporting Entity

The National Security Act of 1947 established the Department of Defense. The Department's mission is to organize, train, and equip armed forces to deter aggression and, if necessary, defeat aggressors against the United States and its allies. Fiscal Year (FY) 2004 is the ninth year that the Department has prepared audited DOD Agency-wide financial statements as required by the Chief Financial Officers Act and Government Management Reform Act. Auditors are required to audit the financial statements of the following stand-alone reporting entities: (1) Army General Fund, (2) Army Working Capital Fund, (3) Navy General Fund, (4) Navy Working Capital Fund, (5) Air Force General Fund, (6) Air Force Working Capital Fund, (7) Military Retirement Fund, (8) DoD Medicare-Eligible Retiree Health Care Fund, and (9) U.S. Army Corps of Engineers (Civil Works).

In addition to the nine stand-alone reporting entities, separate columns in the combining/consolidating statements are included with the financial information of the "Other Defense Organizations General Funds" and "Other Defense Organizations Working Capital Funds." The Office of the Inspector General will not issue separate audit opinions on the statements of the Other Defense Organizations; instead, the financial statements and records of those organizations will be included in the audit performed to support the opinion issued on the DoD Agency-wide financial statements.

Also, the Department requires the following Defense Agencies to prepare internal stand-alone annual financial statements to be audited by certified public accounting firms: (1) Defense Logistics Agency, (2) Defense Finance and Accounting Service, (3) Defense Information Systems Agency, (4) Defense Contract Audit Agency, (5) Defense Commissary Agency, (6) Defense Security Service, and (7) Defense Threat Reduction Agency.

1.C. Appropriations and Funds

The Department receives its appropriations and funds as general, working capital (revolving funds), trust, special, and deposit funds. The Components use these appropriations and funds to execute their missions and report on resource usage.

General funds are used for financial transactions funded by congressional appropriations, including personnel, operation and maintenance, research and development, procurement, and military construction accounts.

Trust funds contain receipts and expenditures of funds held in trust by the government for use in carrying out specific purposes or programs in accordance with the terms of the donor, trust agreement, or statute.

Special fund accounts are used to process government receipts earmarked for a specific purpose.

Deposit funds are used to record amounts held temporarily until ownership is determined. The Department is acting as an agent or a custodian for funds awaiting distribution, for example payroll taxes.

Working capital funds (WCF) receive their initial funding through an appropriation or a transfer of resources from existing appropriations or funds and use those capital resources to finance the initial cost of products and services. The activities provide goods and services on a reimbursable basis. Receipts derived from operations generally are available in their entirety for use without further congressional action.

1.D. Basis of Accounting

For FY 2004, the Department's financial management systems are unable to meet all of the requirements for full accrual accounting. Many of the Department's financial and nonfinancial feeder systems and processes were designed and implemented prior to the issuance of GAAP for federal agencies and, therefore, were not designed to collect and record financial information on the full accrual accounting basis as required by GAAP. Most of the Department's legacy systems were designed to record information on a budgetary basis.

The Department has undertaken efforts to determine the actions required to bring its financial and nonfinancial feeder systems and processes into compliance with all elements of GAAP. One such action is the current revision of its accounting systems to record transactions based on the United States Government Standard General Ledger (USSGL). Until all of the Department's financial and nonfinancial feeder systems and processes are updated to collect and report financial information as required by GAAP, the DoD's financial data will be based on budgetary transactions (obligations, disbursements, and collections), transactions from nonfinancial feeder systems, and adjusted for known accruals of major items such as payroll expenses, accounts payable, and environmental liabilities.

In addition, the Department identifies program costs based upon the major appropriation groups provided by the Congress. The Department is in the process of reviewing available data and attempting to develop a cost reporting methodology that balances the need for cost information required by the Statement of Federal Financial Accounting Standards (SFFAS) No. 4, "Managerial Cost Accounting Concepts and Standards for the Federal Government," with the need to keep the financial statements from being overly voluminous.

1.E. Revenues and Other Financing Sources

The Department receives congressional appropriations as financing sources for general funds (annual and a multi-year basis). When authorized, these appropriations are supplemented by revenues generated by sales of goods or services. The Department recognizes revenue as a result of costs incurred or services performed on behalf of other federal agencies and the public. The Department recognizes revenue when earned where systems allow for it. In other instances, revenue is recognized when bills are issued.

The Department does not include non-monetary support provided by U.S. allies for common defense and mutual security in its list of other financing sources that appears in the Statement of Financing. The U.S. has cost-sharing agreements with other countries. Examples include countries where there is a mutual or reciprocal defense agreement, where U.S. troops are stationed, or where the U.S. fleet is in a port.

1.F. Recognition of Expenses

For financial reporting purposes, the DoD policy requires the recognition of operating expenses in the period incurred. However, because the Department's financial and nonfinancial feeder systems were not designed to collect and record financial information on the full accrual accounting basis, accrual adjustments are made for major items such as payroll expenses, accounts payable, environmental liabilities and unbilled revenue. The Department's expenditures for capital and other long-term assets are recognized as operating expenses based on depreciation. In the case of Operating Materials and Supplies (OM&S), operating expenses are generally recognized when items are either purchased or issued to users. Efforts are underway to migrate towards the consumption method for recognizing OM&S expenses. Net increases or decreases in unexpended appropriations are recognized as a change in the net position. Certain expenses, such as annual and military leave earned but not taken, are expensed in the period that payment is made. The Department adjusts operating expenses as a result of the elimination of balances between DoD Components.

1.G. Accounting for Intragovernmental Activities

The Department, as an agency of the federal government, interacts with and is dependent upon the financial activities of the federal government as a whole. Therefore, these financial statements do not reflect the results of all financial decisions applicable to the Department.

Public Debt

The Department's proportionate share of public debt and related expenses of the federal government are not included. The federal government does not apportion debts and its related costs to federal agencies. The DoD's financial statements, therefore, do not report any portion of the public debt or interest thereon, nor do the statements report the source of public financing whether from issuance of debt or tax revenues.

Financing for the construction of DoD facilities is obtained through appropriations. To the extent this financing ultimately may have been obtained through the issuance of public debt, interest costs have not been capitalized since the Department of the Treasury does not allocate such interest costs to the benefiting agencies.

Inter/Intra Governmental Elimination

Preparation of reliable financial statements requires the elimination of transactions occurring among entities within the Department or between two or more federal agencies. However, the Department cannot accurately identify most of its intragovernmental transactions by customer because DoD's systems do not track buyer and seller data needed to match related transactions. For FY 1999 and beyond, seller entities within the Department provided summary seller-side balances for revenue, accounts receivable, and unearned revenue to the buyer-side internal DoD accounting offices. In most cases, the buyer-side records have been adjusted to recognize unrecorded costs and accounts payable. Intra-DoD intragovernmental balances were then eliminated. The Department is to develop long-term systems improvements that will include sufficient up-front edits and controls to eliminate the need for after-the-fact reconciliations. The volume of intragovernmental transactions is so large that after-the-fact reconciliation cannot be accomplished effectively with the existing or foreseeable resources.

The Department of the Treasury Financial Management Service (FMS) is responsible for eliminating transactions between the Department and other federal agencies. In May 2004, the FMS issued the Treasury Financial Manual Part 2 – Chapter 4700 “Agency Reporting Requirements for the Financial Report of the United States Government.” The Department is not able to fully implement the policies and procedures in this manual related to reconciling intragovernmental assets, liabilities, revenues, and expenses for nonfiduciary transactions. The Department, however, is able to implement the policies and procedures contained in the “Intragovernmental Fiduciary Transactions Accounting Guide,” as updated by the “Federal Intragovernmental Transactions Accounting Policies and Procedures Guide,” which has been updated and reissued on September 24, 2004. Both documents provide guidance for reconciling Intragovernmental transactions pertaining to investments in federal securities, borrowings from the U.S. Treasury and the Federal Financing Bank, Federal Employees' Compensation Act transactions with the Department of Labor (DoL), and benefit program transactions with the OPM.

1.H. Transactions with Foreign Governments and International Organizations

Each year, the DoD Components sell defense articles and services to foreign governments and international organizations, primarily under the provisions of the "Arms Export Control Act of 1976." Under the provisions of the Act, the Department has authority to sell defense articles and services to foreign countries and international organizations, generally at no profit or loss to the U.S. Government. Customers are required to make payments in advance.

1.I. Funds with the U.S. Treasury

The Department's monetary financial resources are maintained in U.S. Treasury accounts. The Defense Finance and Accounting Service (DFAS), the Military Services, the U.S. Army Corps of Engineers (USACE) disbursing stations, and the Department of State financial service centers process the majority of cash collections, disbursements, and adjustments worldwide. Each disbursing station prepares monthly reports that provide information to the U.S. Treasury on check issues, electronic fund transfers, and interagency transfers and deposits.

In addition, the DFAS sites and the USACE Finance Center submit reports to the Department of the Treasury, by appropriation, on interagency transfers, collections received, and disbursements issued. The Department of the Treasury then records this information to the applicable Fund Balance with Treasury (FBWT) account. Differences between the Department's recorded balance in the FBWT accounts and the Treasury's FBWT accounts sometimes result and are subsequently reconciled.

1.J. Foreign Currency

Cash is the total of cash resources under the control of the Department of Defense, which includes coin, paper currency, negotiable instruments, and amounts held for deposit in banks and other financial institutions. Cash available for agency use includes petty cash funds and cash held in revolving funds, which will not be transferred into the U.S. Government General Fund. Foreign currency consists of the total U.S. dollar equivalent of both purchased and non-purchased foreign currencies held in foreign currency fund accounts. The majority of cash and all foreign currency is classified as non-entity and, therefore, restricted.

The amounts for cash and foreign currency reported consist primarily of cash held by Disbursing Officers to carry out their paying, collecting and foreign currency accommodation exchange missions. Cash seized during Operation Iraqi Freedom is restricted for use to assist the Iraqi people and support the reconstruction of Iraq.

The Department conducts a significant portion of its operations overseas. The Congress established a special account to handle the gains and losses from foreign currency transactions for five general fund appropriations (operation and maintenance, military personnel, military construction, family housing operation and maintenance, and family housing construction). The gains and losses are computed as the variance between the exchange rate at the date of payment and a budget rate established at the beginning of each fiscal year. Foreign currency fluctuations related to other appropriations require adjustments to the original obligation amount at the time of payment. The Department does not separately identify currency fluctuations.

1.K. Accounts Receivable

As presented in the Balance Sheet statement, accounts receivable includes accounts, claims, and refunds receivable from other Federal entities or from the public. Allowances for uncollectible accounts due from the public are based upon analysis of collection experience by fund type. The Department does not recognize an allowance for estimated uncollectible amounts from other Federal agencies. Claims against other Federal agencies are to be resolved between the agencies (per Code of Federal Regulations 4CFR 101.)

DoD Components use a variety of techniques for estimating the Allowance for Uncollectible Accounts Receivable from the public. While the exact details differ among the Components, estimates are usually based on either a percentage of actual prior-year write-offs or a percentage of aged receivables from the public.

1.L. Loans Receivable

The Department operates a loan guarantee program authorized by the National Defense Authorization Act for FY 1996 Public Law 104-106, Statute 186, Section 2801. The Act includes a series of authorities that allow the Department to work with the private sector to renovate military housing. The Department's goals are to obtain private capital to leverage government dollars, make efficient use of limited resources, and use a variety of private sector approaches to build and renovate military housing faster and at a lower cost to American taxpayers.

The Act also provides the Department with a variety of authorities to obtain private sector financing and expertise to improve military housing. The Department uses these authorities individually or in combination. They include guarantees, both loan and rental; conveyance/leasing of existing property and facilities; differential lease payments; investments, both limited partnerships and stock/bond ownership; and direct loans. In addition, the "Federal Credit Reform Act of 1990" governs all amended direct loan obligations and loan guarantee commitments made after FY 1991 resulting in direct loans or loan guarantees.

1.M. Inventories and Related Property

Most of the Department's inventories are currently reported at an approximation of historical cost using latest acquisition cost adjusted for holding gains and losses. The latest acquisition cost method is used because legacy inventory systems were designed for materiel management rather than accounting. Although these systems provide visibility and accountability over inventory items, they do not maintain historical cost data necessary to comply with SFFAS No. 3, "Accounting for Inventory and Related Property." Additionally, these systems cannot produce financial transactions using the USSGL, as required by the Federal Financial Management Improvement Act of 1996 (P.L. 104-208). By utilizing new systems development processes, the DoD Components have transitioned, and are continuing to transition, their inventory to the moving average cost method. Upon full implementation, the Department will be compliant with SFFAS No. 3. Approximately 5 percent of inventories are now reported at moving average cost.

The Department manages only military or government-specific materiel under normal conditions. Items commonly used in and available from the commercial sector are not managed in the DoD materiel management activities. Operational cycles are irregular, and the military risks associated with stock-out positions have no commercial parallel. The Department holds materiel based on military need and support for contingencies. Therefore, the Department does not attempt to account separately for "Inventory held for sale" and "Inventory held in reserve for future sale" based on SFFAS No. 3 definitions.

Related property includes OM&S and stockpile materials. OM&S, including munitions not held for sale, are valued at standard purchase price. The Department uses both the consumption method and the purchase method of accounting for OM&S. Items that are centrally managed and stored, and procured by general fund appropriations such as ammunition and engines, are generally accounted by the consumption method and reported on the balance sheet as OM&S. When current systems cannot fully support the consumption method, the Department uses the purchase method - that is, materials and supplies are expensed when purchased. For FY 2004, the Department expensed significant amounts using the purchase method either because the systems could not support the consumption method or because management deemed that the item is in the hands of the end user.

The Department determined that the recurring high dollar value of Operating Materials & Supplies in need of repair is material to the financial statements and requires a separate reporting category. Many high dollar items managed, such as aircraft engines, are categorized as OM&S rather than military equipment by DoD activities.

The Department implemented new policy in FY 2002 to account for condemned materiel only, as "Excess, Obsolete, and Unserviceable." The net value of condemned materiel is zero, because the costs of disposal are greater than the

potential scrap value. Potentially redistributable materiel, presented in previous years as “Excess, Obsolete, and Unserviceable,” is included in “Held for Use” or “Held for Repair” categories according to its condition.

Past audit results identified uncertainties about the completeness and existence of quantities used to produce the reported values of inventory. Inventory available and purchased for resale includes consumable spare and repair parts and repairable items owned and managed by the Department. This inventory is retained to support military or national contingencies. Inventory held for repair is damaged inventory that requires repair to make suitable for sale. It is more economical to repair than to procure these inventory items. Because the Department often relies on weapon systems and machinery no longer in production, the Department supports a process that encourages the repair and rebuilding of certain items. This repair cycle is essential to maintaining a ready, mobile, and armed military force. Finally, work in process balances include costs related to the production or servicing of items, including direct material, direct labor, applied overhead and other direct costs. Work in process also includes the value of finished products or completed services pending the submission of bills to the customer. The work in process designation may also be used to accumulate the amount paid to a contractor under cost reimbursable contracts, including the amount withheld from payment to ensure performance, and the amount paid to other government plants for accrued costs of end items of materiel ordered but not delivered. Work in process includes munitions in production and depot maintenance work with its associated labor, applied overhead, and supplies used in the delivery of maintenance services.

1.N. Investments in U.S. Treasury Securities

The Department reports investments in U.S. Treasury securities at cost, net of amortized premiums or discounts. Premiums or discounts are amortized into interest income over the term of the investment using the effective interest rate method or another method obtaining similar results. The Department’s intent is to hold investments to maturity, unless they are needed to finance claims or otherwise sustain operations. Consequently, a provision is not made for unrealized gains or losses on these securities.

The Department invests in both marketable and non-marketable securities. Marketable securities are investments trading on a public market. The two types of non-marketable securities are par value and market-based intragovernmental securities. The Bureau of Public Debt issues non-marketable par value intragovernmental securities. Non-marketable, market-based intragovernmental securities mimic marketable securities, but are not traded publicly.

The Department’s Net Investments are supported by various Trust Funds in each of the reporting entities. These Trust Funds are comprised of Military Retirement Trust Fund (MRF), Medicare-Eligible Retiree Health Care Fund (MERHCF), Other Defense Organizations General Fund (ODO GF), donations (Gift Funds), and the United States Army Corps of Engineers (USACE).

1.O. General Property, Plant and Equipment

SFFAS No. 23 establishes new generally accepted accounting principles for valuing and reporting military equipment (e.g., ships, aircraft, combat vehicles, weapons) in Federal financial statements. The standard requires the capitalization and depreciation of the cost of military equipment, including the cost of modifications and upgrades for accounting periods beginning after September 30, 2002. The Department uses data from the Bureau of Economic Analysis to calculate a value for military equipment.

General PP&E assets are capitalized at historical acquisition cost plus capitalized improvements when an asset has a useful life of 2 or more years, and when the acquisition cost equals or exceeds the DoD capitalization threshold of \$100,000. Also, DoD requires capitalization of improvement costs over the DoD capitalization threshold of \$100,000 for General PP&E. The Department depreciates all General PP&E, other than land, on a straight-line basis.

Prior to FY 1996, General PP&E was capitalized if it had an acquisition cost of \$15,000, \$25,000, and \$50,000 for FYs 1993, 1994, and 1995, respectively, and an estimated useful life of 2 or more years. These assets remain

capitalized and reported on WCF financial statements. General PP&E previously capitalized at amounts below \$100,000 were written off General Fund financial statements in FY 1998.

The USACE Civil Works General PP&E assets are capitalized at historical acquisition cost plus capitalized improvements when an asset has a useful life of 2 or more years, and when the acquisition cost exceeds \$25,000. One exception is all buildings and structures related to hydropower projects are capitalized regardless of cost. During 2003, the Corps increased its buildings and structures threshold from \$0 to \$25K for all Civil Works appropriations with the exception of Revolving Fund and Power Marketing Agency (PMA) assets. All Civil Works buildings and structures currently capitalized under \$25,000 (excluding Revolving Fund and PMA) were expensed in FY 2003 and removed from the Corps of Engineers Financial Management System (CEFMS). Beginning in FY 2004 all Civil Works Buildings and Structures under \$25,000 are expensed except for PMA assets.

When it is in the best interest of the government, the Department provides government property necessary to contractors to complete contract work. The Department either owns or leases such property, or it is purchased directly by the contractor for the government based on contract terms. When the value of contractor-procured General PP&E exceeds the DoD capitalization threshold, it must be reported on the Department's Balance Sheet.

Regardless, the Department is developing new policies and a contractor reporting process that will provide appropriate General PP&E information for future financial statement reporting purposes. Accordingly, the Department reports only the government property in the possession of contractors that is maintained in the DoD's property systems. Currently the Department does not plan to show contractor-held property as a separate line-item in Note 10.

To bring the DoD into fuller compliance with federal accounting standards, the Department has issued new property accountability and reporting regulations that require the DoD Components to maintain, in their property systems, information on all property furnished to contractors. This action and other DoD proposed actions are structured to capture and report the information necessary for compliance with federal accounting standards.

1.P. Advances and Prepayments

The Department records payments in advance of the receipt of goods and services as advances or prepayments and reports them as assets on the Balance Sheet. In addition, when the Department receives the related goods and services, it recognizes advances and prepayments as expenses.

1.Q. Leases

Generally, lease payments are for the rental of equipment and operating facilities and are classified as either capital or operating leases. When a lease is essentially equivalent to an installment purchase of property (a capital lease), the Department records the applicable asset and liability if the value equals or exceeds the current DoD capitalization threshold. The Department records the amounts as the lesser of the present value of the rental and other lease payments during the lease term (excluding portions representing executory costs paid to the lessor) or the asset's fair market value. The discount rate for the present value calculation is either the lessor's implicit interest rate or the governmental incremental borrowing rate at the inception of the lease. DoD as the lessee receives the use and possession of leased property, for example real estate or equipment, from a lessor in exchange for a payment of funds. An operating lease does not substantially transfer all the benefits and risk of ownership. Payments for operating leases are charged to expense over the lease term as it becomes payable.

Office space is the largest component of operating leases. These costs were gathered from existing leases, General Service Administration (GSA) bills, and Inter-service Support Agreements. Future year projections use the Consumer Price Index (CPI), rather than the DoD inflation factor. The CPI impacts increases to the leases, especially those at commercial lease sites. Equipment leases have a variety of lease terms, which are not expected to be renewed upon expiration. Other operating leases are generally one-year leases. The Department expects to continue to reduce the level of owned assets while increasing the number of leased assets. The Department will strive to displace commercial leases with more economical GSA leases.

Note 9.	Inventory and Related Property
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As of September 30 (Amounts in millions)	2004	2003
1. Inventory, Net	\$ 68,207.9	\$ 64,365.4
2. Operating Materials & Supplies, Net	143,489.7	139,351.2
3. Stockpile Materials, Net	1,521.8	1,828.0
4. Total	\$ 213,219.4	\$ 205,544.6

Inventory, Net

As of September 30 (Amounts in millions)	2004			2003		Valuation Method
	Inventory, Gross Value	Revaluation Allowance	Inventory, Net	Inventory, Net		
1. Inventory						
A. Available and Purchased for Resale	\$ 75,931.7	\$ (33,557.2)	42,374.5	\$ 42,216.0		LAC, MAC
B. Held for Repair	30,027.6	(5,369.7)	24,657.9	20,206.3		LAC, MAC
C. Excess, Obsolete, and Unserviceable	5,368.1	(5,368.1)	0.0	0.0		NRV
D. Raw Materials	21.3	0.0	21.3	9.8		MAC, SP, LAC
E. Work in Process	1,154.2	0.0	1,154.2	1,933.3		AC
F. Total	\$ 112,502.9	\$ (44,295.0)	68,207.9	\$ 64,365.4		

Legend for Valuation Methods:

Adjusted LAC = Latest Acquisition Cost, adjusted for holding gains and losses
 SP = Standard Price

NRV = Net Realizable Value
 MAC = Moving Average Cost
 AC = Actual Cost

Generally, there are no restrictions on the use, sale, or disposition of inventory except in the following situations:

- Distributions without reimbursement are made when authorized by Department of Defense directives.
- War reserve materiel includes fuels and subsistence items that are considered restricted.
- Inventory, with the exception of safety stocks, may be sold to foreign, state and local governments, private parties, and contractors in accordance with current policies and guidance or at the direction of the President.

General Composition of Inventory

Inventory includes spare and repair parts, clothing and textiles, and fuels held for sale by the Defense Working Capital Funds. Inventory is tangible personal property that is:

- Held for sale, or held for repair for eventual sale.
- In the process of production for sale.
- To be consumed in the production of goods for sale or in the provision of services for a fee.

Restatement of Prior Year Balance

Inventory, Net and Total Inventory and Related Property include a prior-year adjustment and restatement of \$11.4 billion for fiscal year 2003. The restatement of the 2003 comparative balances is due to Inventory valuation changes and errors recorded by the Air Force. Refer to Note 20 – Statement of Changes in Net Position for additional information.

Operating Materials and Supplies, Net

As of September 30	2004			2003	Valuation Method
	OM&S Gross Value	Revaluation Allowance	OM&S, Net	OM&S, Net	
(Amounts in millions)					
1. OM&S Categories:					
A. Held for Use	\$ 127,765.1	\$ 0.0	\$ 127,765.1	\$ 122,732.3	SP, LAC
B. Held for Repair	18,035.4	(2,310.8)	15,724.6	16,618.9	SP, LAC
C. Excess, Obsolete, and Unserviceable	3,128.9	(3,128.9)	0.0	0.0	NRV
D. Total	\$ 148,929.4	\$ (5,439.7)	\$ 143,489.7	\$ 139,351.2	

Legend for Valuation Methods:

Adjusted LAC = Latest Acquisition Cost
adjusted for holding gains and losses

NRV = Net Realizable Value.
SP = Standard Price

Generally, there are no restrictions on the use or disposition of operating materials and supplies.

General Composition of Operating Materials and Supplies

Operating Materials and Supplies includes spare and repair parts, ammunition, tactical missiles, aircraft configuration pods, and centrally managed aircraft engines held for consumption by General Funds. Generally, there are no restrictions on the use or disposition of operating materials and supplies.

Fluctuations

OM&S increased by \$4.1 billion (3 percent). The primary factors are as follows:

The Army General Fund reported its OM&S increased by \$5.1 billion. The net increase is attributable to an increase in Missile Procurement, Army OM&S reported by the U. S. Army Aviation and Missile Command and an increase being reported in the Worldwide Ammunition Reporting System (WARS). The Missile Procurement's increase is the result of movement of funding from Procurement, Defense-wide to Missile Procurement, Army for the Patriot Advance Capability 3 in support of the global war on terror. The WARS increase is the result of Operation Iraqi Freedom, movement to uses other than basic load and training, retrograde and asset movement from troops to ammunition storage points, and Central Command inventory reconciliation.

The Air Force General Fund reported a decrease of \$1.1 billion because of a change in methodology for valuing its OM&S. In FY 2003, uninstalled motors were valued at Latest Acquisition Cost while in FY 2004, they were valued at Moving Average Cost. Many of the old uninstalled missile motors reported in FY 2003 as excess have been refurbished and are now being reported as "held for use," and some motors have been destroyed.

Stockpile Materials, Net

As of September 30	2004			2003	Valuation Method
	Stockpile Materials Amount	Allowance for Gains (Losses)	Stockpile Materials, Net	Stockpile Materials, Net	
(Amounts in millions)					
1. Stockpile Materials Categories:					
A. Held for Sale	\$ 1,427.7	\$ 0.0	\$ 1,427.7	\$ 1,691.8	AC,LCM AC,LCM
B. Held in Reserve for Future Sale	94.1	0.0	94.1	136.2	
C. Total	\$ 1,521.8	\$ 0.0	\$ 1,521.8	\$ 1,828.0	

Legend for Valuation Methods:

AC = Actual Cost

LCM = Lower of Cost or Market

Fluctuations

Stockpile, Net decreased \$306.2 million (16.7 percent). The National Stockpile Fund reported the decrease of \$42.1 million in its inventory held in reserve for future use is due to a systemic programming error in 2003 which was subsequently corrected. The decrease of \$264.1 million in inventory held for sale is the result of material sales in FY 2004. Since the National Stockpile mission does not call for replenishing inventories, there will always be an annual decline of inventory.

General Composition of Stockpile Materials

Stockpile materials are strategic and critical materials held due to statutory requirements, for use in national defense, conservation or national emergencies. All materials held by the Defense National Stockpile (DNS) are classified as Materials Held in Reserve until congressional action declares the materials are no longer required to be stockpiled, and are available for sale on the open market. When DNS receives authorization to offer materials for sale, DNS removes the materials from Material Held in Reserve and reclassifies them as Material Held for Sale. Disposals cannot be made from the stockpile except under the following situations: (1) necessary upgrading, refining, or processing; (2) necessary rotation to prevent deterioration; (3) determination as excess with potential financial loss if retained; and (4) as authorized by law.

Note 10. General PP&E, Net

As of September 30	2004					2003
	Depreciation / Amortization Method	Service Life	Acquisition Value	(Accumulated Depreciation/ Amortization)	Net Book Value	Prior FY Net Book Value
(Amounts in millions)						
1. Major Asset Classes:						
A. Land	N/A	N/A	\$ 10,103.0	N/A	\$ 10,103.0	\$ 9,663.4
B. Buildings, Structures, and Facilities	S/L	20 Or 40	159,446.9	(91,463.2)	67,983.7	76,388.0
C. Leasehold Improvements	S/L	lease term	139.1	(96.3)	42.8	96.2
D. Software	S/L	2-5 Or 10	6,051.9	(3,555.9)	2,496.0	2,392.7
E. General Equipment	S/L	5 or 10	45,285.8	(29,314.0)	15,971.8	338,054.2
F. Military Equipment	S/L	Various	1,147,340.0	(822,900.0)	324,440.0	0.0
G. Assets Under Capital Lease ¹	S/L	lease term	585.9	(379.2)	206.7	233.6
H. Construction-in-Progress	N/A	N/A	19,574.6	N/A	19,574.6	19,388.3
I. Other			83.1	(3.1)	80.0	92.5
J. Total General PP&E			\$ 1,388,610.3	\$ (947,711.7)	\$ 440,898.6	\$ 446,308.9

¹ See Note 15 on Capital Lease Liability for additional information

Legend for Valuation Methods:

S/L = Straight Line N/A = Not Applicable

Fluctuations

General Property, Plant and Equipment (PP&E) decreased \$5.4 billion (1 percent). The significant changes are summarized below:

Buildings, Structures and Facilities decreased 8.4 billion (11 percent). The majority of this decrease was the result of an error in Navy General Fund data captured for FY 2003 accumulated depreciation. This error was corrected in FY 2004.

Leasehold Improvements reflected a net decrease of \$53.4 million (56 percent). The decrease is primarily attributable to the DFAS Working Capital Fund's one-time reclassification of \$48.3 million from Buildings, Structures and Facilities to Leasehold Improvements in FY 2003.



INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
400 ARMY NAVY DRIVE
ARLINGTON, VIRGINIA 22202-4704

November 12, 2004

**MEMORANDUM FOR UNDER SECRETARY OF DEFENSE
(COMPTROLLER)/CHIEF FINANCIAL OFFICER**

SUBJECT: Independent Auditor's Report on the Fiscal Year 2004 DoD Agency-Wide Financial Statements (Report No. D-2005-017)

The Chief Financial Officers Act of 1990, as amended by the Federal Financial Management Act of 1994, requires Federal agency Inspectors General appointed under the Inspector General Act of 1978, as amended, to audit their respective agency's financial statements or determine that "an independent external auditor" should conduct such audits. Pursuant to this statutory authority, the undersigned Inspector General of the Department of Defense assumed responsibility for auditing the accompanying DoD Agency-Wide Consolidated Balance Sheet as of September 30, 2004 and 2003, the related Consolidated Statement of Net Cost, the Consolidated Statement of Changes in Net Position, the Combined Statement of Budgetary Resources, the Combined Statement of Financing, and the Statement of Custodial Activity for the fiscal years then ended.

The financial statements are the responsibility of DoD management. DoD is also responsible for implementing effective internal control and for complying with laws and regulations. We are unable to give an opinion on the Fiscal Year 2004 financial statements of DoD because of limitations on the scope of our work. Thus, the financial statements may be unreliable. In addition to our disclaimer of opinion on the financial statements, we are including the required Report on Internal Control and Compliance With Laws and Regulations. The Report on Internal Control and Compliance With Laws and Regulations is an integral part of our disclaimer of opinion on the financial statements and should be considered in assessing the results of the audit.

Disclaimer of Opinion on the Financial Statements

The Under Secretary of Defense (Comptroller)/Chief Financial Officer acknowledged to us that (1) the FY 2004 DoD Agency-Wide Financial Statements would not substantially conform to generally accepted accounting principles and (2) DoD financial management and feeder systems were unable to adequately support material amounts on the financial statements as of September 30, 2004. Therefore, we did not perform auditing procedures to determine whether material amounts on the financial statements were fairly presented. We did not perform these and other auditing procedures because Section 1008(d) of the FY 2002 National Defense Authorization Act limits the Inspector General of the Department of Defense to perform only audit procedures required by generally accepted government auditing standards that are consistent with the representations made by management. DoD has also acknowledged, and prior audits have identified, the material weaknesses listed in the Summary of Internal Control. These material weaknesses also

"A regular Statement and Account of the Receipts and Expenditures of all public Money shall be published from time to time." - Constitution of the United States, Article I, Section 9

affect the reliability of certain information contained in the annual financial statements—much of which is taken from the same data sources as the principal financial statements.¹ As described above, we are unable to express, and we do not express, an opinion on the financial statements and the accompanying information.

Summary of Internal Control

In planning our audit, we considered DoD internal control over financial reporting and compliance. We did this to determine our procedures for auditing the financial statements and to comply with Office of Management and Budget guidance but our purpose was not to express an opinion on internal control. Accordingly, we do not express an opinion on internal control over financial reporting and compliance. However, previously identified reportable conditions,² all of which are material, continued to exist in the following areas:

- Financial Management Systems;
- Fund Balance with Treasury;
- Inventory;
- Operating Materials and Supplies;
- General Property, Plant, and Equipment (PP&E);
- Government-Furnished Material and Contractor-Acquired Material;
- Environmental Liabilities;
- Intragovernmental Eliminations;
- Other Accounting Entries;
- Statement of Net Cost; and
- Statement of Financing.

A material weakness is a condition that precludes the entity's internal control from providing reasonable assurance that misstatements, losses, or noncompliance that are material in relation to the financial statements would be prevented or detected on a timely basis. Our internal control work would not necessarily disclose all material weaknesses. See the Attachment for additional details on material internal control weaknesses.

¹ The annual financial statements include the principal financial statements, management discussion and analysis, consolidating and combining financial statements, Required Supplementary Stewardship Information, Required Supplementary Information, and Other Accompanying Information.

² Reportable conditions are matters coming to the auditor's attention that, in his or her judgment, should be communicated to management because they represent significant deficiencies in the design or operation of internal control, which could adversely affect the organization's ability to initiate, record, process, and report financial data consistent with the assertions of management in financial statements.

"A regular Statement and Account of the Receipts and Expenditures of all public Money shall be published from time to time." - Constitution of the United States, Article I, Section 9

Summary of Compliance With Laws and Regulations

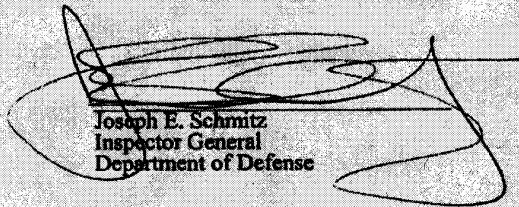
Our work to determine compliance with selected provisions of applicable laws and regulations related to financial reporting was limited because management acknowledged, and prior audits confirm, that instances of noncompliance continue to exist. The Under Secretary of Defense (Comptroller)/Chief Financial Officer acknowledged to us that DoD financial management systems do not comply substantially with Federal financial management system requirements, generally accepted accounting principles, and the U.S. Government Standard General Ledger at the transaction level. Therefore, we did not determine whether DoD was in compliance with all applicable laws and regulations related to financial reporting. See the Attachment for additional details on compliance with laws and regulations.

Management Responsibility


Management is responsible for:

- preparing the financial statements in conformity with generally accepted accounting principles;
- establishing, maintaining, and assessing internal control to provide reasonable assurance that the broad control objectives of the Federal Managers' Financial Integrity Act (FMFIA) are met; and
- complying with applicable laws and regulations.

We provided a draft of this report to personnel in the Office of the Under Secretary of Defense (Comptroller)/Chief Financial Officer who provided technical comments, which have been incorporated as appropriate. These officials expressed their continuing commitment to address the problems this report outlines.



Joseph E. Schmitz
Inspector General
Department of Defense



Paul J. Granetto, CPA
Assistant Inspector General
Defense Financial Auditing Service

Attachment:
As stated

"A regular Statement and Account of the Receipts and Expenditures of all public Money shall be published from time to time." - Constitution of the United States, Article I, Section 9

Report on Internal Control and Compliance With Laws and Regulations

Internal Control

Management is responsible for implementing effective internal control and for providing reasonable assurance that accounting data are accumulated, recorded, and reported properly and that assets are safeguarded against misappropriation and abuse. Our purpose was not to, and we do not, express an opinion on internal control over financial reporting. However, management acknowledged that previously identified reportable conditions, all of which are material, continue to exist. The following financial management deficiencies are indications of material weaknesses in internal control that may adversely affect any decision by DoD that is based, in whole or in part, on information that is inaccurate because of these deficiencies. Financial information reported by DoD also may contain misstatements resulting from these deficiencies.

Financial Management Systems. Statement of Federal Financial Accounting Concepts (SFFAC) No. 1, "Objectives of Federal Financial Reporting," requires financial management systems controls that are adequate to ensure that transactions are executed in accordance with budgetary and financial laws and other requirements, are consistent with the purposes authorized, and are recorded in accordance with Federal accounting standards. SFFAC No. 1 also requires that financial management systems controls ensure that assets are properly safeguarded to deter fraud, waste, and abuse; and that performance measurement information is adequately supported. The Under Secretary of Defense (Comptroller)/Chief Financial Officer acknowledged that many DoD financial management systems do not substantially comply with Federal financial management systems requirements. DoD financial management and feeder systems were not designed to adequately support various material amounts on the financial statements. These systemic deficiencies in financial management and feeder systems and inadequate DoD business processes result in the inability to collect and report financial and performance information that is accurate, reliable, and timely.

Fund Balance with Treasury. DoD is required by the Treasury Financial Manual and DoD Financial Management Regulation 7000.14-R, to resolve financial and accounting inconsistencies to accurately report Fund Balance with Treasury. However, inconsistencies continue to exist related to in-transit disbursements, unmatched disbursements, negative unliquidated obligations, unreconciled differences in suspense accounts, and unreconciled differences between U.S. Treasury records and DoD accounting records.

Inventory. DoD is required by the Statement of Federal Financial Accounting Standards (SFFAS) No. 3, "Accounting for Inventory and Related Property," to use historical cost or the latest acquisition cost adjusted for holding gains and losses or moving average cost for valuing inventory. However, DoD acknowledged that the existing inventory valuation at most activities does not

Attachment

approximate historical cost. Additionally, DoD does not distinguish between Inventory Held for Sale and Inventory Held in Reserve for Future Sale, as required by SFFAS No. 3.

Operating Materials and Supplies. SFFAS No. 3 also states that Operating Materials and Supplies must be expensed when the items are consumed. DoD has acknowledged that significant amounts of Operating Materials and Supplies were expensed when purchased instead of when they were consumed. In addition, DoD acknowledged that significant amounts of Operating Materials and Supplies in the possession of contractors were not included in the Operating Materials and Supplies account balance.

General Property, Plant, and Equipment. DoD is required by SFFAS No. 6, "Accounting for Property, Plant, and Equipment," to record PP&E at acquisition cost, capitalize improvement costs, and recognize depreciation expense. However, DoD has acknowledged that it is unable to accurately report the value of PP&E on its financial statements. DoD legacy property and logistic systems were not designed to capture acquisition cost, costs of modifications and upgrades, or calculate depreciation. In addition, value of DoD PP&E is not reliably reported because of a lack of supporting documentation.

Government-Furnished Material and Contractor-Acquired Material. SFFAS No. 11, "Amendments to Accounting for Property, Plant, and Equipment," requires that property and equipment in the possession of a contractor for use in accomplishing a contract be considered Government property. Government property should be accounted for based on the nature of the item, regardless of who has possession. DoD has acknowledged, and prior audits confirm, that it is unable to comply with applicable requirements for Government-Furnished Materials and Contractor Acquired-Materials. As a result, the value of DoD property and material in the possession of contractors is not reliably reported.

Environmental Liabilities. DoD acknowledged that guidance and audit trails for estimating environmental liabilities are incomplete. Environmental liability estimates were unreliable because activities did not have effective controls in place to ensure that adequate audit trails and supporting documentation for estimates exist, and that they comply with established guidance in developing estimates and maintain reliable feeder and coordination systems. In addition, material uncertainties exist related to environmental cleanup because of incomplete documentation for cleanup costs.

Intragovernmental Eliminations. DoD acknowledged that it made unverifiable adjustments because of the inability to reconcile most intragovernmental transactions. For example, the Defense Finance and Accounting Service-Indianapolis entered more than \$59 billion in unsupported adjustments to Army intragovernmental accounts to bring them into agreement with related amounts reported by its trading partners.

Other Accounting Entries. DoD acknowledged that it continues to enter material amounts of unsupported accounting entries. For example, the Defense Finance and Accounting Service-Indianapolis recorded \$204.8 billion (excluding adjustments for intragovernmental transactions) in unsupported accounting entries to prepare the FY 2004 Army General Fund Financial Statements.

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Statement of Net Cost. SFFAC No. 2, "Entity and Display," requires the Statement of Net Cost to provide an understanding of the net costs of each organization and each program. In addition, the Statement of Net Cost should provide gross and net cost information that can be related to the amounts of outputs and outcomes for the programs and/or organization. DoD acknowledged the following deficiencies related to the Statement of Net Cost.

- The amounts presented for General Funds may not report actual accrued costs.
- Although the funds are generally recorded on an accrual basis for Working Capital Funds, as is required by generally accepted accounting principles, the systems do not always capture actual costs in a timely manner.
- Current financial processes and systems do not capture and report accumulated costs for major programs based on performance measures as required by the Government Performance and Results Act.
- DoD accounting systems do not capture cost data in a manner that enables DoD to determine if the costs were incurred to generate intragovernmental revenue.
- DoD accounting systems do not capture trading partner data at the transaction level in a manner that facilitates trading partner aggregations. Consequently, DoD was unable to reconcile intra-governmental revenue balances with its trading partners.

Statement of Financing. SFFAS No. 7, "Accounting for Revenue and Other Financing Sources and Concepts for Reconciling Budgetary and Financial Accounting," states that the Statement of Financing should reconcile resources obligated during the period to the net cost of operations. However, DoD acknowledged that it is unable to reconcile budgetary obligations to net costs without making adjustments. Specifically, budgetary data are not in agreement with proprietary expenses. DoD disclosed in Note 22 that the Statements of Financing and Net Cost were adjusted by \$10,071.7 million (absolute value) to bring them into agreement. Lastly, DoD presented the Statement of Financing on a combined basis instead of a consolidated basis as required by Office of Management and Budget (OMB) Bulletin No. 01-09, "Form and Content of Agency Financial Statements."

Compliance With Laws and Regulations

Management is responsible for compliance with existing laws and regulations related to financial reporting. Our work to determine compliance with selected provisions of the applicable laws and regulations was limited because management acknowledged instances of noncompliance, and previously reported instances of noncompliance continued to exist. Therefore, we did not determine whether DoD was in compliance with selected provisions of all applicable laws and regulations related to financial reporting. Our objective was not to, and we do not, express an opinion on compliance with applicable laws and regulations.

Attachment

Statutory Financial Management Systems Reporting Requirements. DoD is required to comply with the following financial management systems reporting requirements.

- Section 3512, title 31, United States Code, incorporates the reporting requirements of the FMFIA of 1982 and requires DoD to evaluate its systems and to annually report whether those systems are in compliance with requirements prescribed by the Comptroller General.
- The Federal Financial Management Improvement Act (FFMIA) of 1996 requires DoD to establish and maintain financial management systems that comply substantially with Federal financial management systems requirements, applicable Federal accounting standards, and the U.S. Government Standard General Ledger at the transaction level. The FFMIA also requires DoD to develop a remediation plan when its financial management systems do not comply with Federal financial management systems requirements. The remediation plan is to include remedies, resources required, and milestones.

For FY 2004, DoD did not fully comply with the statutory reporting requirements identified in these provisions. Specifically, DoD acknowledged that many of its critical financial management and feeder systems did not comply substantially with Federal financial management systems requirements, Federal accounting standards, and the U.S. Government Standard General Ledger at the transaction level as of September 30, 2004. In an attempt to remedy these long-standing financial management systems deficiencies, DoD is developing a DoD-Wide Business Enterprise Architecture. However, the Business Enterprise Architecture falls short of meeting the requirements of a remediation plan under the FFMIA because the architecture does not identify the resources required to correct the noncompliance with Federal financial management system requirements. Until the architecture is fully developed and implemented, DoD will continue to be unable to fully comply with the statutory reporting requirements. We did not perform tests of compliance for these requirements.

Antideficiency Act. Title 31, section 1341 of the United States Code states that an officer or employee of the United States Government may not “make or authorize an expenditure or obligation exceeding an amount available in an appropriation or fund for the expenditure or obligation;” or “involve either government in a contract or obligation for the payment of money before an appropriation is made unless otherwise authorized by law.” During FY 2004 DoD completed 33 investigations of potential violations of the Antideficiency Act, and determined that 21 were actual violations.

In response to violations of the Antideficiency Act, title 31, sections 1351 and 1349 require DoD to immediately report the nature of violations to the President and Congress and to take appropriate disciplinary action against those responsible for the violations. In a recent audit of Antideficiency Act cases closed in FYs 2002 and 2003,³ we identified that DoD was not reporting Antideficiency Act violations to the President and Congress in a timely manner. Additionally, the audit identified that DoD Components did not consistently take appropriate

³ OIG DoD Audit Report No. D-2005-0003, “DoD Antideficiency Act Reporting and Disciplinary Process,” October 14, 2004

Attachment

5

disciplinary action against personnel responsible for violations of the Antideficiency Act. Our review of Antideficiency Act investigations closed in FY 2004 showed that delays continue; however, DoD is taking aggressive action to significantly reduce the time to investigate and report violations.

Prompt Payment Act. The Prompt Payment Act requires DoD to maintain an internal control environment in accordance with OMB Circular A-123 "Management Accountability and Control." In prior audit reports, we identified outstanding deficiencies in the DoD internal control environment as it relates to payments. Specifically, deficiencies related to access and accountability for resources, recording, and documentation have not been corrected.

Audit Disclosures

We did not perform audit work related to the following selected provisions of laws and regulations: Government Performance and Results Act, Debt Collection Improvement Act, Federal Credit Reform Act, and the Pay and Allowance System for Civilian Employees.

This report does not include recommendations to correct the material internal control weaknesses and instances of noncompliance because previous audit reports contained recommendations for corrective actions.

Attachment

Office of the Under Secretary of Defense (Comptroller) (OUSD(C))



Preparing for an Audit

Final Examination

Student Name: _____

Prepared by:
Science Applications International Corporation
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Final Examination

Directions This is an open-book final examination covering subject matter taught in this course. It will assess your knowledge of requirements for preparing for an audit. The final examination consists of questions that are multiple choice and fill in the blank. Write in or circle the correct answer to the questions.

Time Allocation The time allocated to this examination is 40 minutes: 30 minutes for the exercise and 10 minutes for the critique.

Number	Question
1	<p>Which of the following items has the highest priority in the hierarchy of accounting principles and standards for U.S. government reporting entities?</p> <ul style="list-style-type: none">a. Office of Management and Budget (OMB) Form and Content Bulletinsb. FASAB Statements, Interpretations, and FASAB-approved AICPA and FASB Pronouncementsc. DoD Financial Management Regulation policies and guidanced. Office of the Secretary of Defense (Comptroller) policies and guidance
2	<p>What is the Historical Cost Principle?</p> <ul style="list-style-type: none">a. A generally accepted accounting principle in which entities are required to account and report based on acquisition cost rather than fair market valueb. A generally accepted accounting principle in which costs are calculated based on the fair market value of the acquisition at the time of purchasec. A generally accepted accounting principle in which acquisition cost is depreciated based on the inflation rate over the life of the purchased. A generally accepted accounting principle in which costs are calculated from their historical value to their current value

Number	Question
3	<p>What entity is responsible for financial statement audits within the DoD?</p> <ul style="list-style-type: none">a. DoDIGb. Army Audit Agencyc. Naval Audit Serviced. Air Force Audit Agency
4	<p>What are three types of audits?</p> <ul style="list-style-type: none">a. Compliance, operational, and accounting auditsb. Internal control, system control, and financial statements auditsc. Financial statements, performance or operational, and system auditsd. Economy, efficiency, and effectiveness audits
5	<p>Which of the following are annual reports required by OMB Circular A-123, Management Accountability and Control?</p> <ul style="list-style-type: none">a. A Statement of Assurance and a Statement of Assurance for Internal Control over Financial Reportingb. An assessment of the financial position of the entity and an explanation of the abnormal balancesc. A Statement of Net Cost and a Balance Sheetd. A report of accountable entities and a report on material weaknesses
6	<p>What entity was created to promote and support financial management in the executive branch of the federal government?</p> <ul style="list-style-type: none">a. Office of Federal Financial Management (OFFM)b. Government Accountability Office (GAO)c. American Institute of Certified Public Accountants (AICPA)d. Financial Accounting Standards Board (FASB)

Number	Question
7	<p>What is the effect on the financial statements if intragovernmental eliminations are not conducted?</p> <ul style="list-style-type: none">a. Overstatement of assets, liabilities, revenues, and expensesb. Understatement of assets, liabilities, revenues, and expensesc. All public transactions are doubledd. No effect
8	<p>What is represented by the Balance Sheet?</p> <ul style="list-style-type: none">a. An organization's financial position as of a specific timeb. Components of the net cost for each of the reporting entity's operations for the period based on accrual or proprietary accountingc. How budgetary resources were made available and what their status is at the end of the period.d. How the Statement of Budgetary Resources and the Statement of Net Cost relate to each other
9	<p>The Yellow Book contains standards for audits of government organizations, programs, activities, and functions. What are these standards often referred to as?</p> <ul style="list-style-type: none">a. Generally Accepted Accounting Principles (GAAP)b. Statements of Federal Financial Accounting Standards (SFFAS)c. Statements of Federal Financial Accounting Concepts (SFFAC)d. Generally Accepted Government Auditing Standards (GAGAS)

Number	Question
10	<p>The GAO/PCIE FAM is composed of two volumes. What is described in Volume 1?</p> <ul style="list-style-type: none">a. Audit processb. Checklist for Federal Accounting, Reporting, and Disclosuresc. Formats for financial statementsd. Purpose of the entrance conference
11	<p>Who is required to follow up on audit recommendations and correct problems resulting from inadequate, excessive, or poorly designed controls?</p> <ul style="list-style-type: none">a. Auditorsb. Managersc. DoD reporting entitiesd. DFAS
12	<p>In what phase of the audit cycle does the auditor gain an understanding of the entity's operations?</p> <ul style="list-style-type: none">a. Internal Control Phaseb. Reporting Phasec. Planning Phased. Testing Phase
13	<p>What is the five-phase process designed to prepare entities to pass a financial audit and to improve their ability to control and report on their financial activities?</p> <ul style="list-style-type: none">a. Business Management Modernization Program (BMMP)b. Financial Management Balanced Scorecardc. Financial Management Transformation Pland. Financial Improvement Initiative

Number	Question
14	<p data-bbox="435 247 1417 321">Name three sources for the identification of problems or deficiencies that must be corrected.</p> <div data-bbox="435 380 964 527"><hr/><hr/><hr/></div>
15	<p data-bbox="435 556 1015 594">What is the purpose of the Validation Phase?</p> <div data-bbox="435 625 1377 940"><ul style="list-style-type: none"><li data-bbox="435 625 967 663">a. To validate the analysis of the auditors<li data-bbox="435 695 1154 732">b. To validate the effectiveness of the corrective actions<li data-bbox="435 764 1377 840">c. To notify the DoDIG that validation of corrected deficiencies has been completed and that a financial statement or line item is ready for audit<li data-bbox="435 871 1339 940">d. To determine the reliability of the line or statement which the entity asserted as being ready for audit</div>

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